

# **FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2009**

WEDNESDAY, APRIL 16, 2008

U.S. SENATE,  
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,  
*Washington, DC.*

The subcommittee met at 3 p.m., in room SD-192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.  
Present: Senator Durbin, Brownback, and Allard.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENT OF DOUGLAS SHULMAN, COMMISSIONER

ACCOMPANIED BY:

**RICHARD SPIRES, DEPUTY COMMISSIONER**

**LINDA STIFF, DEPUTY COMMISSIONER**

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. This hearing will come to order.

I am pleased to welcome you to this session before the Financial Services and General Government Appropriations Subcommittee. My colleagues will be joining me a little later on, and I will certainly welcome them.

Our focus today is on the President's fiscal year 2009 budget request for the Internal Revenue Service (IRS). It is a perfect day, is it not, the day after tax day?

Funding for the IRS alone constitutes just over one-half of the total amount requested by the administration for the nearly 30 agencies under this subcommittee's jurisdiction. Each year IRS employees make hundreds of millions of contacts with American taxpayers and businesses, and the IRS represents the face of Government to more U.S. citizens than any other agency.

Appearing before the subcommittee is a distinguished group of witnesses. They bring valuable expertise and public service experiences in their lives to this hearing today, and I appreciate it.

First, I am going to welcome Douglas Shulman, now in his fourth week—4 weeks now, Mr. Commissioner—as the 47th Commissioner of the Internal Revenue Service of the United States. Thank you for embarking on this challenge.

Joining us on the second panel will be three of IRS's key partners and watchdogs: J. Russell George, Treasury Inspector General for Tax Administration; Paul Cherecwich, Chairman of the IRS Oversight Board; and Nina Olson, National Taxpayer Advocate. I appreciate their work and look forward to their testimony.

PREPARED STATEMENT OF THE GOVERNMENT ACCOUNTABILITY OFFICE

I also want to acknowledge the helpful contributions of the Government Accountability Office (GAO) in response to our request for analysis. I welcome senior GAO officials: James R. White, Director of Strategic Issues, and David Powner, Director of Information Technology, Management Issues; and other members of their team. Their prepared statement will be a part of the record, and they stand ready to respond to questions.

[The statement follows:]

PREPARED STATEMENT OF JAMES R. WHITE, DIRECTOR, STRATEGIC ISSUES,  
GOVERNMENT ACCOUNTABILITY OFFICE

INTERNAL REVENUE SERVICE: ASSESSMENT OF THE FISCAL YEAR 2009 BUDGET  
REQUEST

HIGHLIGHTS

*Why GAO Did This Study*

The fiscal year 2009 budget request for the Internal revenue Service (IRS) is a road map for how IRS plans to allocate resources and achieve ambitious goals for improving taxpayer service, increasing research, and continuing to invest in modernized information systems. One complicating factor in implementing IRS's plans in the immediate future is the recent passage of the Economic Stimulus Act of 2008, which creates additional, unanticipated workload for IRS.

GAO was asked to (1) assess how the President's budget request for IRS allocates resources and justifies proposed initiatives; (2) determine the status of IRS's efforts to develop and implement its Business Systems Modernization (BSM) program; and (3) determine the total costs of administering the economic stimulus legislation. To meet these objectives, GAO drew upon and updated recently issued reports.

*What GAO Recommends*

GAO is not making new recommendations, but the statement highlights outstanding recommendations to extend the use of return on investment (ROI) analysis to cover major enforcement programs and improve BSM management controls and capabilities.

*What GAO Found*

The President's fiscal year 2009 budget request for IRS is \$11.4 billion, 4.3 percent more than last year's enacted amount. The request proposes to maintain taxpayer service at recent levels, in part by realizing efficiency gains from electronic filing, despite a decrease in staffing. It also proposes a 7 percent increase in enforcement spending, including spending for 21 legislative and nonlegislative initiatives. The legislative proposals are projected to cost \$23 million in fiscal year 2009, funding that IRS would not need if the proposals are not enacted. Similarly, if IRS were to fall behind in its proposed enforcement hiring efforts, it would not need all \$226 million of the associated funding. IRS justified its nonlegislative enforcement initiatives with ROI analyses, which are useful, despite limitations, for making resource allocation decisions. The budget request does not provide ROI information for activities that constitute a large part of the budget request—activities other than the proposed initiatives.

The request for BSM is over \$44 million lower than the fiscal year 2008 enacted amount. IRS said this funding level will allow it to continue its primary modernization projects, but it did not describe how specific projects or benefits to taxpayers would be affected. IRS has continued to make progress in implementing BSM projects and improving modernization management controls and capabilities. However, further improvements are needed. For example, the agency has yet to develop long-term plans for completing BSM and consolidating and retiring legacy systems.

IRS estimated that the costs of implementing the economic stimulus legislation may be up to a total of \$767 million—including a \$202 million supplemental appropriation. In addition to the supplemental appropriation, IRS is reallocating hundreds of collections staff to answering taxpayer telephone calls, resulting in up to \$565 million in foregone enforcement revenue. In addition, IRS expects some deterioration in telephone service because of the increased call volume. For example, IRS is expecting its assistor level of service to drop to as low as 74 percent compared to its goal of 82 percent.

THE PRESIDENT'S FISCAL YEAR 2009 REQUEST FOR IRS FULL-TIME EQUIVALENTS (FTES)  
COMPARED TO FISCAL YEAR 2008 ENACTED BUDGET FTES

Appropriation	Fiscal year 2008 enacted	Fiscal year 2009 requested	Percentage change
Enforcement .....	47,349	49,792	+ 5.2
Taxpayer Service .....	31,218	30,792	– 1.4
Operations Support .....	12,181	11,989	– 1.6
BSM .....	358	333	– 7.0
Health Insurance Tax Credit .....	17	16	– 5.9
Total .....	91,123	92,922	+ 2.0

Source: GAO analysis of IRS data.

Mr. Chairman and Members of the Subcommittee: We appreciate this opportunity to comment on the President's fiscal year 2009 budget request for the Internal Revenue Service (IRS).

Financing of the Federal Government depends largely on IRS's ability to effectively administer the tax laws. The President has requested \$11.4 billion in program dollars to fund IRS's fiscal year 2009 operations, including \$11.1 billion for service to taxpayers and tax law enforcement, plus \$223 million for the BSM program, IRS's ongoing effort to improve the agency's business and tax processing systems.

The fiscal year 2009 budget request is a road map for how IRS intends to allocate resources in order to carry out ambitious plans of improving enforcement, improving taxpayer service, increasing research, and continuing to invest in modernized information systems. Together with the budget request, IRS's recently published strategies spell out its intentions for improving taxpayer service and reducing the net tax gap—the difference between the taxes owed and eventually paid, most recently estimated at \$290 billion for tax year 2001.<sup>1</sup> The budget request and strategies aim to build on recent IRS accomplishments such as annually bringing in more revenue through enforcement and making progress on modernizing IRS's business and tax processing systems. One complicating factor for carrying out IRS's ambitious plans in the immediate future is the recent passage of the Economic Stimulus Act of 2008, which creates additional, unanticipated workload for IRS this year.<sup>2</sup> Passage of this act required IRS to act quickly to deal with taxpayers' questions and begin issuing payments.

Based on your request, our objectives were to (1) assess how the President's budget request for IRS for fiscal year 2009 allocates resources for enforcement, service, research, and systems modernization primarily compared to fiscal year 2008 enacted levels; (2) assess the rationales for differences between the 2 years, including the rationales for initiatives and the extent to which those rationales have been justified; (3) determine the status of IRS's efforts to develop and implement its BSM program; and (4) determine the total cost of administering the economic stimulus program.

To meet these objectives, we drew upon and updated a recently issued report on the budget request and IRS's 2008 tax filing season, and for our BSM work, we relied primarily on our review of the fiscal year 2008 BSM expenditure plan.<sup>3</sup> For the first report, we compared enacted and requested budgets for IRS; reviewed documents, including estimates of revenues and costs from initiatives; and interviewed

<sup>1</sup> Internal Revenue Service, *Reducing the Federal Tax Gap* (Washington, D.C.: Aug. 2, 2007); and Internal Revenue Service, *The 2007 Taxpayer Assistance Blueprint* (Washington, D.C.: 2007).

<sup>2</sup> Pub. L. No. 110–185 (2008).

<sup>3</sup> GAO, *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, GAO–08–567 (Washington, D.C.: Mar. 13, 2008) and GAO, *Business Systems Modernization: Internal Revenue Service's FISCAL Year 2008 Expenditure Plan*, GAO–08–420 (Washington, D.C.: Mar. 7, 2008).

IRS officials. For our BSM report, we analyzed the expenditure plan, reviewed other documents, and interviewed IRS officials. In assessing the cost of the economic stimulus package, we obtained performance and production data, looking for factors that significantly affected performance, and we interviewed IRS officials. We conducted the current performance audit from March 2008 through April 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. For a more detailed discussion of our scope and methodology, see the appropriate sections in the budget and filing season and the BSM reports.

In summary, we make the following major points:

- The President's budget request for IRS proposes to maintain taxpayer service at recent levels and increase enforcement. Overall, it increases spending on IRS by 4.3 percent. Spending on taxpayer service would increase by less than 1 percent, which would result in reduced staffing, but the level of taxpayer service would be maintained by realizing efficiency gains, in part, through increases in electronic filing. The budget proposes a 7 percent increase in enforcement spending, including funds and staffing for various legislative and nonlegislative initiatives. According to the proposal, the legislative initiatives would raise about \$36 billion in revenue over 10 years. They are projected to cost \$23 million in fiscal year 2009, funding IRS would not need if none of the legislative initiatives were enacted. Similarly, if IRS were to fall behind in meeting its challenging hiring goals for the nonlegislative initiatives, it would not need all \$226 million of the associated funding for fiscal year 2009.
- IRS included more information than past years on the initiatives in the fiscal year 2009 proposed budget. Of particular note, IRS included return on investment (ROI) information for all nonlegislative initiatives. However, beyond those initiatives, the budget request does not provide an analytic basis for key resource allocation decisions. Such decisions include allocating resources among a variety of enforcement programs and taxpayer services. Analytic data such as ROI can be helpful to IRS's management and the Congress for making these decisions as well as decisions about the overall balance between taxpayer service and enforcement. Although the budget request provides performance measure data, it does not provide ROI for programs or activities that constitute a large part of the budget request—activities other than the proposed initiatives.
- The requested budget for BSM is over \$44 million lower than the fiscal year 2008 enacted amount of about \$267 million and roughly \$185 million less than the amount the IRS Oversight Board is proposing. Modernized e-File (MeF) is the project with the largest difference between the requested budget and the fiscal year 2008 enacted amount. IRS stated that the requested BSM funding level will allow it to continue developing and delivering its primary modernization projects but did not provide details on how plans to deliver specific projects or benefits to taxpayers would be affected. IRS continues to make progress in implementing BSM projects and meeting cost and schedule commitments for most deliverables, but three project milestones recently experienced significant cost or schedule delays.<sup>4</sup> IRS has also taken steps to address our prior recommendations; however, work remains to fully implement them, including developing long-term plans for completing the BSM program. Future releases of the Customer Account Data Engine (CADE) and Account Management Services (AMS) continue to face risks and challenges, which IRS is working to mitigate. Finally, we recently recommended that IRS complete a plan with specific time frames for implementing initiatives supporting its information technology (IT) human capital strategy, and IRS agreed.
- IRS estimates that the cost of implementing the economic stimulus legislation may be up to a total of \$767 million, including a \$202 million supplemental appropriation. In addition to the supplemental appropriation, IRS is reallocating resources from enforcement to taxpayer service by shifting hundreds of collections staff to answering telephone calls and, as a result, may forego up to \$565 million in enforcement revenue. IRS has experienced a deterioration of telephone access and expects a further decline. For example, IRS's assistor level of service—which measures a taxpayer's ability to get through and speak to an assistor—has already declined, and IRS expects access to continue to drop to as low as 74 percent, down from the fiscal year 2008 goal of 82 percent.

<sup>4</sup> Milestones represent different phases in IRS's project life cycle.

THE FISCAL YEAR 2009 BUDGET REQUEST PROPOSES TO MAINTAIN TAXPAYER SERVICE AT RECENT LEVELS AND INCREASE ENFORCEMENT

The President's budget request is proposing to maintain taxpayer service levels with fewer staff by realizing efficiency gains; it also proposes to increase enforcement by adding staff. The President's fiscal year 2009 budget request of \$11.4 billion for IRS is 4.3 percent more than the fiscal year 2008 enacted budget and represents an increase of less than 1 percent for taxpayer service and 7 percent for enforcement, as shown in table 1.

TABLE 1.—THE PRESIDENT'S FISCAL YEAR 2009 REQUEST FOR IRS COMPARED TO THE FISCAL YEAR 2008 ENACTED BUDGET  
[Dollars in thousands]

Program	Fiscal year 2008 enacted	Fiscal year 2009 requested	Percentage change
Enforcement .....	\$6,997,226	\$7,487,209	+ 7.0
Taxpayer Service .....	3,612,833	3,636,230	+ 0.6
BSM .....	267,090	222,664	– 16.6
Health Insurance Tax Credit .....	15,235	15,406	+ 1.1
Total .....	10,892,384	11,361,509	+ 4.3

Note: Dollar amounts include amounts for operations support.

Source: GAO analysis of IRS data.

The budget request increases IRS-wide staff levels, measured in full-time equivalents (FTEs), by 2 percent, with a 1.4 percent decrease in taxpayer service FTEs and a 5.2 percent increase in enforcement FTEs, as shown in table 2.

TABLE 2.—THE PRESIDENT'S FISCAL YEAR 2009 REQUEST FOR IRS FTES COMPARED TO FISCAL YEAR 2008 ENACTED BUDGET FTES

Appropriation	Fiscal year 2008 enacted	Fiscal year 2009 requested	Percentage change
Enforcement .....	47,349	49,792	+ 5.2
Taxpayer Service .....	31,218	30,792	– 1.4
Operations Support .....	12,181	11,989	– 1.6
BSM .....	358	333	– 7.0
Health Insurance Tax Credit .....	17	16	– 5.9
Total .....	91,123	92,922	+ 2.0

Note: The decline in taxpayer services, including operations support, reflects 91 FTEs in efficiency savings and 207 FTEs in electronic filing savings. The increase in enforcement, including operations support, includes an additional 1,431 revenue agents and 582 revenue officers who will work on initiatives.

Source: GAO analysis of IRS data.

The President's budget proposal is consistent with longer-term trends for IRS. Compared to actual spending in fiscal year 2006, the proposed fiscal year 2009 budget increases taxpayer service funding by 3.7 percent, a real decrease after inflation, while increasing IRS's enforcement funding by 10 percent.

The budget request proposes to maintain taxpayer service at recent levels. As an example, the key taxpayer service measures shown in table 3 are projected to remain relatively stable through fiscal year 2009.

TABLE 3.—TELEPHONE SERVICE MEASURES  
[In percent]

Measure	Fiscal year 2006 actual	Fiscal year 2007 actual	Fiscal year 2008 planned	Fiscal year 2009 planned
Telephone performance—access: Assistor level of service (percentage of taxpayers who wanted to talk with an assistor and actually got through and received service) .....	82.0	82.1	82.0	82.0

TABLE 3.—TELEPHONE SERVICE MEASURES—Continued

[In percent]

Measure	Fiscal year 2006 actual	Fiscal year 2007 actual	Fiscal year 2008 planned	Fiscal year 2009 planned
Telephone performance—accuracy:				
Tax law customer accuracy (percentage of calls in which telephone assistants provided accurate answers on tax law and took appropriate action) .....	90.9	91.2	91.0	91.0
Accounts customer accuracy (percentage of calls in which telephone assistants provided accurate answers on customer accounts and took appropriate action) .....	93.2	93.4	93.5	93.7

Source: GAO analysis of IRS data.

In order to maintain taxpayer service at recent levels despite a decrease in real spending and staffing, IRS expects to realize efficiency gains. For instance, IRS expects to devote 207 fewer FTEs to the labor-intensive processing of paper returns because of expected increases in electronic filing. These expected efficiency gains are consistent with past trends—between 1999 and 2007, IRS reduced staff devoted to processing paper returns by about 1,800 FTEs.

IRS's ability to maintain or improve taxpayer service beyond 2009 will likely depend on its ability to continue to improve efficiency. To this end, in recent reports, we made recommendations to further increase electronic filing. We recommended that IRS determine the actions needed to require software vendors to include bar codes on printed returns, and we suggested that the Congress mandate electronic filing by certain paid tax preparers.<sup>5</sup> IRS agreed with our bar code recommendation and outlined the actions it would take.

Some of the real spending decrease proposed for fiscal year 2009 is because of one-time investments made in fiscal year 2008 or carryovers in funds from fiscal year 2008. For instance, the budget request proposes a \$31 million reduction in funding for taxpayer assistance centers and outreach. However, IRS officials told us that this reduction includes funding used for long-term investments in fiscal year 2008 that would not need to be duplicated in fiscal year 2009. IRS officials also told us that a \$7.7 million decrease in funding for the Taxpayer Advocate offsets a funding increase in fiscal year 2008 that is being used to lower the Advocate's outstanding caseload. Finally, an \$8 million reduction in the Volunteer Income Tax Assistance (VITA) program reflects fiscal year 2008 funding that was not spent and carried over into fiscal year 2009.<sup>6</sup>

The budget request for IRS's enforcement programs includes nonlegislative and legislative initiatives. According to the proposal, the five nonlegislative enforcement initiatives would cost about \$338 million in fiscal year 2009 and are expected to raise about \$2 billion of direct revenue annually starting in fiscal year 2011.<sup>7</sup> In addition, the budget request estimates that the enforcement initiatives would generate at least another \$6 billion annually in indirect revenue. The indirect revenue results from improved voluntary compliance induced by taxpayers' awareness of expanded IRS enforcement. The budget request also proposes increases in examination coverage for corporations with assets of \$10 million or more from a planned 6.6 percent for fiscal year 2008 to 6.8 percent for fiscal year 2009. The coverage rate would in-

<sup>5</sup> GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should Be Evaluated*, GAO-08-38 (Washington, D.C.: Nov. 15, 2007) and GAO, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings*, GAO-07-27 (Washington, D.C.: Nov. 15, 2006).

<sup>6</sup> The funding provided in fiscal year 2008 was 2-year funding. Since IRS was ramping up the program being funded—providing matching grants to volunteer preparer organizations—in 2008, additional funding was not needed for 2009. Despite not asking for additional funding, IRS is expecting to see large, but unquantified, growth in tax returns prepared at VITA sites. According to IRS officials, IRS does not have a separate line item showing how much it spent on VITA overall.

<sup>7</sup> These nonlegislative initiatives involve (1) reducing the tax gap for small businesses and the self-employed; (2) reducing it for large businesses; (3) increasing reporting compliance related to offshore activity; (4) through research, improving tax gap estimates, measurement, and detection of noncompliance; and (5) expanding document matching.

crease to 7.6 percent in fiscal year 2010 as new enforcement staff hired in fiscal year 2009 complete training and can audit more returns.

The budget request includes 16 legislative initiatives budgeted at \$23 million for fiscal year 2009 that it says would raise about \$36 billion in revenue over 10 years; if none were enacted, IRS would not need the \$23 million. We have reported on three of the proposals. In 2006, we suggested that the Congress consider an idea for reducing securities capital gains noncompliance.<sup>8</sup> In 1991, we supported the notion that payments to corporations be reported on information returns.<sup>9</sup> Finally, in 2007, we described ways to mitigate the compliance costs related to these information returns and to other information returns associated with credit and debit card payments.<sup>10</sup>

The revenue expected from IRS's enforcement initiatives is modest compared to the net tax gap, which was last estimated at \$290 billion for tax year 2001. As we noted in our statement to this Committee last year, no single approach, such as IRS enforcement, is likely to fully and effectively address noncompliance.<sup>11</sup> Multiple approaches are needed because noncompliance has multiple causes and spans different types of taxes and taxpayers.

Hiring needed staff for the nonlegislative initiatives will be challenging for IRS's Large and Mid-Size Business (LMSB) and Small Business/Self-Employed (SB/SE) divisions. For instance, the initiatives call for adding 1,431 revenue agents in addition to those who must be replaced from attrition, a high number relative to past years. IRS divisions have previously hired large numbers of staff in a short time because of specific budget initiatives, but officials reported that hiring gradually over time would reduce challenges. If IRS were to fall behind in its hiring efforts, it would not need all \$226 million of the funding for staff for fiscal year 2009 initiatives.

IRS HAS ENHANCED ITS JUSTIFICATIONS FOR INITIATIVES AND COULD BENEFIT FROM USING ROI ANALYSES MORE BROADLY, EVEN WITH THEIR LIMITATIONS

Responding to our recommendations from last year, IRS included more information on initiatives in the fiscal year 2009 proposed budget, including ROI information for all nonlegislative initiatives. Last year, we recommended that IRS have available basic descriptive, cost, and expected performance information on all new initiatives and include such information in future budget submissions.<sup>12</sup> This year, the budget request has sections explicitly entitled, for instance, "Initiative Summary," "Implementation Plan," "Expected Benefits," and "ROI." Four of the five nonlegislative enforcement initiatives for fiscal year 2009 were revisions of fiscal year 2008 initiatives, but with more total funds requested and generally more informative justifications than for fiscal year 2008.

However, IRS's ROI calculations have limitations that reflect the challenges of estimating ROIs. For example, the calculations do not account for benefits that are harder to measure, such as improved voluntary compliance. Another example showing ROI limitations is the \$51 million National Research Project (NRP) initiative for which IRS estimates the ROI to be \$0.40 per \$1.00 invested. NRP funds research audits in order to develop more effective enforcement programs. The ROI calculation only includes direct revenue resulting from the research audits, not the potential for increased revenue from improved enforcement programs; nor does the calculation include the benefits of the Department of the Treasury's use of NRP data to provide the basis for legislative recommendations.

Although the budget request for IRS provides performance measure data, it does not provide ROI analyses for programs or activities other than the new initiatives. As we noted in our recent report, analytic data such as ROI can be helpful to managers and the Congress when making resource allocation decisions.<sup>13</sup> ROI analyses, even with their limitations, can help answer questions such as the following:

—What are the implications for IRS's resource allocation of the lower costs per taxpayer contact for some services compared to others as shown in table 4?

<sup>8</sup> GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

<sup>9</sup> GAO, *Tax Administration: Benefits of a Corporate Document Matching Program Exceed the Costs*, GAO/GGD-91-118 (Washington, D.C.: Sept. 27, 1991).

<sup>10</sup> GAO, *Tax Administration: Costs and Uses of Third-Party Information Returns*, GAO-08-266 (Washington, D.C.: Nov. 20, 2007).

<sup>11</sup> GAO, *Internal Revenue Service: Assessment of the 2008 Budget Request and an Update of 2007 Performance*, GAO-07-719T (Washington, D.C.: May 9, 2007).

<sup>12</sup> GAO-07-719T.

<sup>13</sup> GAO-08-567.

—Are there extra benefits that offset the higher costs of some services, or could costs be reduced by promoting increased reliance on the lower-cost options?

TABLE 4.—COST OF PROVIDING TAXPAYER SERVICE IN FISCAL YEAR 2005

Service	Estimated cost per contact
Answering tax law questions via e-mail .....	\$52.51
Providing assistance at taxpayer assistance centers .....	28.73
Answering correspondence .....	24.97
Providing assistance by assistors via toll-free telephones .....	19.46
Providing assistance through VITA sites .....	12.01
Providing assistance by automation via toll-free telephones .....	0.71
Providing assistance such as downloads and searches on IRS's Web site .....	0.13

Note: IRS reported that these estimates do not fully allocate all indirect overhead and support costs. We have reported that because of long-standing limitations in IRS's cost accounting capability, cost data at this detailed level have not been audited (see, for example, GAO-07-310 and 07-247). From our perspective, it would be important to know more about the indirect and support costs to see if they might significantly change the cost estimates.

Source: GAO analysis of IRS data.

Similar questions can be asked about enforcement based on table 5:

- Is IRS appropriately allocating resources between field audits, often conducted at a taxpayer's business, and correspondence audits, which are simpler and conducted by mail?<sup>14</sup>
- For the rows in table 5 with average recommended additional tax per return greater for correspondence audits than for field audits, could resources be re-allocated from field audits to correspondence audits in order to help close the tax gap?
- Are there other benefits to field audits, such as a greater impact on voluntary compliance, that are not captured in IRS's data?

TABLE 5.—FIELD AND CORRESPONDENCE AUDITS OF SOME BUSINESS CATEGORIES OF TAXABLE INDIVIDUAL INCOME TAX RETURNS, FISCAL YEARS 2006 AND 2007

Type and size of return	Number of returns examined		Average recommended additional tax per return	
	Field	Correspondence	Field	Correspondence
Fiscal year 2006:				
Business nonfarm returns by size of total gross receipts (TGR):				
Under \$25,000 .....	19,801	107,802	\$3,918	\$2,614
\$25,000 under \$100,000 .....	38,722	42,070	5,464	7,600
\$100,000 or more .....	54,716	34,515	25,787	27,863
Fiscal year 2007:				
Business nonfarm returns without earned income tax credit, by size of TGR:				
Under \$25,000 .....	53,092	81,237	4,836	11,048
\$25,000 under \$100,000 .....	31,363	31,513	6,320	11,793
\$100,000 under \$200,000 .....	28,286	28,041	24,582	32,640
\$200,000 or more .....	11,319	1,730	15,959	7,017
Business returns with total positive income at least \$200,000 and under \$1 million .....	17,499	15,280	20,880	33,406

Note: This table does not include all categories of audits. For a number of those categories, field audits produce a higher average recommended additional tax per return than do correspondence audits.

Source: GAO analysis of IRS data.

We recognize that developing ROI estimates for IRS's ongoing programs such as examinations and taxpayer service will be a challenge. However, because of the potential benefits of ROI analyses, we recommended in our previous report on the fiscal year 2009 budget request that the Commissioner of Internal Revenue extend the use of ROI in future budget proposals to cover major enforcement programs. At that time, IRS officials said that because of the short time frame for our report, they did

<sup>14</sup>In fiscal year 2007 correspondence audits took, on average, 1.4 hours to conduct compared to the 30.8-hour average for field audits done at taxpayers' locations and the 7.8-hour average for field audits done at IRS offices.



not have time to fully analyze its recommendations, and, therefore, were unable to respond.<sup>15</sup> We have agreed to meet with IRS to further discuss the ROI recommendation.

FURTHER PROGRESS MADE IN IMPLEMENTING BSM, BUT CHALLENGES AND RISKS  
REMAIN

IRS's BSM program, initiated in 1999, involves the development and delivery of a number of modernized tax administration, internal management, and core infrastructure projects that are intended to provide improved and expanded service to taxpayers as well as IRS internal business efficiencies. Key tax administration projects include CADE, which is intended to provide the modernized database foundation to replace the existing Individual Master File processing system that contains the repository of individual taxpayer information; AMS, which is intended to enhance CADE by providing applications for IRS employees and taxpayers to access, validate, and update accounts on demand; and MeF, which is to provide a single standard for filing electronic tax returns. We recently reported that while IRS has continued to make progress in implementing BSM projects and improving modernization management controls and capabilities, challenges and risks remain, and further improvements are needed.<sup>16</sup>

As shown in table 6, the fiscal year 2009 budget request for the BSM program is less than the enacted fiscal year 2008 budget by over \$44 million and about \$185 million less than the amount the IRS Oversight Board is proposing. When we asked about the impact of this reduction on its operations, IRS told us that the proposed funding level will allow it to continue developing and delivering its primary modernization projects but did not provide details on how plans to deliver specific projects or benefits to taxpayers would be affected. MeF is the project with the largest difference between the requested budget and the fiscal year 2008 enacted amount.

TABLE 6.—BSM FUNDING DIFFERENCES, FISCAL YEAR 2008 AND 2009

[In thousands of dollars]

Project	Fiscal year 2008 enacted	Fiscal year 2009 budget request
Customer Account Data Engine .....	58,500	58,800
Accounts Management Services .....	28,983	26,158
Modernized e-File .....	55,802	25,000
Filing & Payment Compliance .....		
Core Infrastructure .....	39,150	32,000
Architecture, Integration, and Management .....	35,100	35,000
Management Reserve .....	4,310	2,300
Subtotal Capital Investments .....	221,845	179,258
BSM Labor .....	44,000	42,052
Subtotal Program Request .....	265,845	221,310
Maintaining Current Levels .....	1,245	1,354
Total BSM Budget Request .....	267,090	222,664

Source: IRS data.

IRS has made progress in implementing BSM projects and meeting cost and schedule commitments for most deliverables, but three project milestones experienced significant cost or schedule delays.<sup>17</sup> During 2007, IRS completed milestones of the Filing and Payment Compliance (F&PC), a tax collection case analysis support system; MeF; CADE; and AMS. Our analysis of reported project costs and completion dates showed that 13 of the 14 associated project milestones that were scheduled for completion during this time were completed within 10 percent of cost estimates, and 11 of the 14 milestones were completed within 10 percent of schedule estimates. However, a milestone for CADE exceeded its planned schedule by 66 percent and experienced a 15 percent cost increase; another milestone for the same

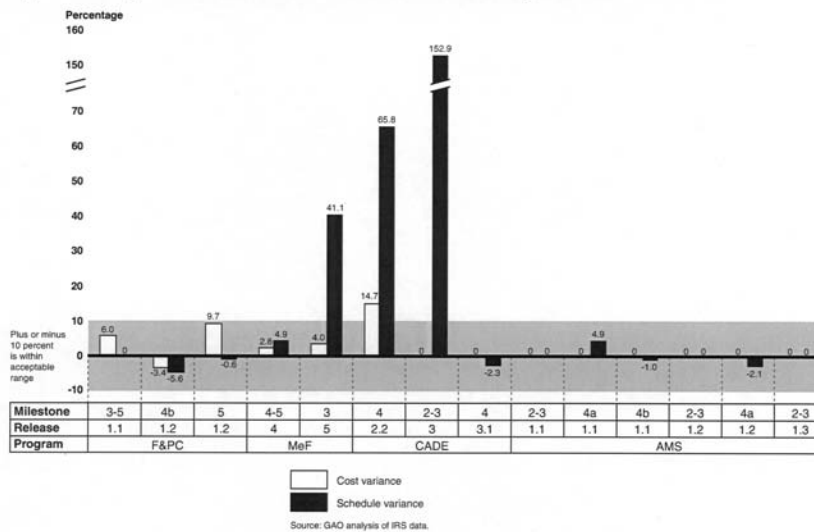
<sup>15</sup> GAO-08-567.

<sup>16</sup> GAO-08-420.

<sup>17</sup> Milestones represent different phases in IRS's project life cycle.

project incurred a 153 percent schedule delay, and a milestone for MeF experienced a 41 percent schedule delay (see fig. 1).

Figure 1: Summary of Cost and Schedule Performance for Fiscal Year 2007 Project Milestones



IRS has taken steps to address our prior recommendations to improve its modernization management controls and capabilities. However, work remains to fully implement them. For example, in July 2005, we recommended that IRS fully revisit the vision and strategy for the BSM program and develop a new set of long-term goals, strategies, and plans consistent with the budgetary outlook and IRS's management capabilities.<sup>18</sup> We also noted that the vision and strategy should include time frames for consolidating and retiring legacy systems. In response, IRS has developed a Modernization Vision and Strategy framework and supporting 5-year Enterprise Transition Plan. However, the agency has yet to develop long-term plans for completing BSM and consolidating and retiring legacy systems. We also recommended in February 2007 that IRS ensure that future BSM expenditure plans include a quantitative measure of progress in meeting scope expectations.<sup>19</sup> We further recommended that, in developing this measure, IRS consider using earned value management since this is a proven technique required by the Office of Management and Budget for measuring cost, schedule, and functional performance against plans.<sup>20</sup> While IRS has developed an approach to address our recommendation, it has not yet fully implemented it.

Future BSM project releases continue to face significant risks and issues, which IRS is addressing. Specifically, the agency recently identified significant risks and issues with planned system deliveries of CADE and AMS and reported that maintaining alignment between the two systems will be a significant challenge and source of risk for the BSM program. IRS recognizes the potential impact of identified risks and issues on its ability to deliver projects within cost and schedule estimates and has developed mitigation strategies to address them. While mitigation strategies have been developed, the risks and challenges confronting future releases of CADE and AMS are nevertheless significant, and we will continue to monitor them and actions to address them.

<sup>18</sup> GAO, *Business Systems Modernization: Internal Revenue Service's Fiscal Year 2005 Expenditure Plan*, GAO-05-774 (Washington, D.C.: July 22, 2005).

<sup>19</sup> GAO, *Business Systems Modernization: Internal Revenue Service's Fiscal Year 2007 Expenditure Plan*, GAO-07-247 (Washington, D.C.: Feb. 15, 2007).

<sup>20</sup> Earned value management is a project management tool that integrates the investment scope of work with schedule and cost elements for investment planning and control. This method compares the value of work accomplished during a given period with that of the work expected in the period. Differences between accomplishments and expectations are measured in both cost and schedule variances.

IRS also made further progress in addressing high-priority BSM program improvement initiatives during the past year. In September 2007, IRS completed another cycle of initiatives and initiated a new cycle, which was scheduled to be completed at the end of March 2008. Initiatives that were addressed in the 6-month cycle ending in September 2007 included IT human capital, information security, and process improvements (e.g., developing and implementing standardized earned value management practices for major projects). IRS's program improvement process continues to be an effective means of regularly assessing, prioritizing, and incrementally addressing BSM issues and challenges. However, more work remains for the agency to fully address these issues and challenges.

Finally, we recently reported that efforts to address human capital challenges continue, but more work remains. IRS developed an IT human capital strategy that addresses hiring critical personnel, employee training, leadership development, and workforce retention, and agency officials stated that they plan to undertake a number of human capital initiatives to support their human capital strategy, including conducting analyses of turnover rates and continuing efforts to replace key leaders lost to retirement. However, a specific plan with time frames for implementing these initiatives has not been developed. We recommended that IRS complete such a plan to help guide the agency's efforts in addressing its IT human capital gaps and measure progress in implementing them. IRS agreed with our recommendation and stated that it intends to develop a plan to implement its IT human capital strategy.

IRS ESTIMATES THE COST OF IMPLEMENTING THE ECONOMIC STIMULUS LEGISLATION MAY BE UP TO A TOTAL OF \$767 MILLION AND EXPECTS DECLINES IN SOME TAXPAYER SERVICES

The Economic Stimulus Act of 2008 is resulting in a significant workload increase not anticipated in the fiscal year 2008 budget. As part of the legislation, IRS received \$202 million in a supplemental appropriation. However, because IRS could not find an alternative according to responsible officials, it has reallocated resources from enforcement to taxpayer service and is allowing some deterioration in telephone service.

IRS will begin sending economic stimulus payments to more than 130 million households in early May, after the current tax filing season, and is scheduled to be done by mid-July. These include an estimated 20 million retirees and disabled veterans, and low-wage workers who usually are exempt from filing a tax return but will be eligible for stimulus payments. Taxpayers required to file a tax return must do so by April 15 in order to receive a stimulus payment by mid-July.<sup>21</sup> People who are not required to file a tax return, but are doing so to receive a stimulus payment, are required to file an IRS Form 1040A by October 15, 2008.

As part of the legislation, IRS received a supplemental appropriation of \$202 million to help fund its costs for implementing the stimulus package. This funding will remain available until September 30, 2009. As shown in table 7, IRS plans to spend the bulk of the funding—\$151.4 million—for Operations Support, most of it on postage for two mass mailings and on IT support. IRS also expects to spend \$50.7 million for Taxpayer Services, including \$26.2 million for staffing and overtime for telephone assistants. IRS is expecting 2.4 million additional telephone calls in March and April with questions for IRS assistants about the economic stimulus legislation. These calls are in addition to the more than 14 million calls typically answered by IRS assistants between January and mid-April.

TABLE 7.—IRS'S ESTIMATED COSTS OF IMPLEMENTING THE ECONOMIC STIMULUS LEGISLATION  
[Dollars in millions]

	2008 goal	Revised estimate	Amount
Supplemental appropriation:			
Operations Support:			
Postage .....			\$90.613
IT support .....			\$43.965
Telecommunications .....			\$8.370
Printing .....			\$6.767
Communications plan .....			\$1.700

<sup>21</sup>Taxpayers who are unable to meet the April 15 filing deadline can file a Form 4868, the automatic extension of time to file, which gives them until October 15 to submit a 2007 tax return.

TABLE 7.—IRS'S ESTIMATED COSTS OF IMPLEMENTING THE ECONOMIC STIMULUS LEGISLATION—  
Continued  
[Dollars in millions]

	2008 goal	Revised estimate	Amount
Total for Operations Support .....			\$151.415
Taxpayer Services: Additional staffing/overtime .....			\$50.720
Total supplemental funding .....			\$202.135
IRS estimates of foregone revenue from shifting Automated Collection System (ACS) staff: <sup>1</sup>			
Wage and Investment (W&I) .....			\$191.728
Small Business/Self-Employed (SB/SE) .....			\$373.065
Total foregone revenue (up to) .....			\$564.793
Total (up to) .....			\$766.928
Taxpayer service: Assistor level of service (percent) .....	82	( <sup>2</sup> )	( <sup>3</sup> )

<sup>1</sup> Revised as of early April 2008.

<sup>2</sup> As low as 74.

<sup>3</sup> Reduction—Down 8 percentage points.

Source: GAO analysis of IRS and Treasury data.

To help meet the increased telephone demand, IRS is shifting about half of its over 2,000 Automated Collection System (ACS) telephone staff from collecting delinquent taxes to answering economic stimulus telephone calls from March through May.<sup>22</sup> To accommodate this shift, IRS stopped sending out some ACS-generated notices, such as notices of levy, several weeks ago.<sup>23</sup> According to IRS officials, it takes about 3 to 4 weeks before this adjustment in ACS-generated notices affects the ACS workload. IRS originally estimated that the revenue foregone by shifting ACS staff to be up to \$681 million. However, according to IRS officials, in early April, IRS revised its foregone revenue estimate down to \$565 million, shown in table 7, largely because of lower-than-expected demand for telephone assistance in March.<sup>24</sup>

According to IRS officials, IRS's priority is to respond to taxpayers' questions about the stimulus program; therefore, the officials are monitoring call volume and adjusting the number of ACS staff answering telephones accordingly. When call volume is low, ACS staff work on outstanding ACS collection cases. However, IRS officials stated that this work does not produce the same revenue as the ACS-generated notices, particularly revenue generated from notices of levy. When IRS adjusts the volume of ACS-generated notices, it takes several weeks before that adjustment affects ACS workload. IRS officials do not want to resume sending ACS-generated notices until they are sure ACS staffers are available to handle the resulting workload.

Should the lower-than-expected call volume continue, IRS may have an opportunity to shift the ACS staff back to their most productive collection work. This could further reduce the revenue foregone from using ACS staff to answer stimulus-related telephone calls. To date, IRS has not reduced its projections for future stimulus-related call volume. If the projections are reduced, IRS may be able to resume sending out at least some ACS-generated notices.

According to IRS officials, IRS considered alternatives to shifting ACS staff, including contracting out, using other IRS staff, or using Social Security Administration or other Federal staff, but decided the alternatives were not feasible. For example, contracting out was not deemed feasible because of insufficient time to negotiate the contract and conduct background checks and training.

<sup>22</sup> When IRS has completed sending its initial series of notices to tax debtors, it assigns the debts to its collections programs, such as ACS. ACS is an automated telephone-based system designed to call tax debtors. ACS staffers then attempt to talk with tax debtors to try to collect outstanding tax debt. IRS estimated there are about 1,200 ACS staff in its W&I division and about 1,100 in its SB/SE division.

<sup>23</sup> IRS suspended notices sent by ACS examiners, such as final notices before enforcement, collection due process notices, and notices of levy.

<sup>24</sup> IRS arrived at the estimates by taking a 3-year average of dollars collected by closing ACS cases for both its W&I and SB/SE divisions. IRS determined the projected foregone revenue by multiplying the average dollars collected per ACS staff by the projected lost case closures. IRS plans to minimize the use of SB/SE staff because the revenue collected by SB/SE is greater than for W&I.

Another cost—although not measured in dollars—is the decline in telephone service shown in table 7. Because of the increased call volume, IRS expects its assistor level of service to drop from 82 percent (the 2008 goal) to as low as 74 percent—the lowest level since 2002. IRS is already experiencing some declines in telephone service. As of March 29, the level of service had dropped to 80 percent, taxpayers were waiting a minute and a half longer than last year, and they were hanging up 43 percent more often while waiting to speak to an assistor. Between March 3 and March 29, IRS assistants answered over 572,000 stimulus-related calls.<sup>25</sup> IRS expects call volume to increase rapidly in upcoming weeks as taxpayers receive their stimulus notices in the mail.

Because IRS is in the early stages of implementing the stimulus legislation, IRS officials do not have much information about the actual costs. Through March, IRS estimates that it has spent almost \$103 million, mostly for postage.

#### AGENCY COMMENTS

In commenting on a draft of our earlier report on the fiscal year 2009 budget request and 2008 tax filing season, IRS officials said that, because of the short time frame for our report, they did not have time to fully analyze our recommendation and, therefore, were unable to respond at the time. They provided technical comments at that time and again for this statement, and we made those changes where appropriate. We have agreed to meet with IRS to further discuss the ROI recommendation.

Mr. Chairman, this concludes my prepared statement. Mr. Powner and I would be happy to respond to questions that you or other members of the subcommittee may have at this time.

#### PREPARED STATEMENTS OF OMB WATCH AND COLLEEN KELLEY

Senator DURBIN. In addition, written statements have been received from OMB Watch and Colleen Kelley, President of the National Treasury Employees Union, on behalf of the employees of the Internal Revenue Service. Without objection, these materials will be made a part of the permanent record.

[The statements follow:]

#### PREPARED STATEMENT OF COLLEEN M. KELLEY, NATIONAL PRESIDENT, NATIONAL TREASURY EMPLOYEES UNION

Chairman Durbin, Ranking Member Brownback, and distinguished members of the subcommittee, I would like to thank you for allowing me to provide comments on the administration's fiscal year 2009 budget request for the Internal Revenue Service (IRS). As president of the National Treasury Employees Union (NTEU), I have the honor of representing over 150,000 Federal workers in 31 agencies, including the men and women at the IRS.

#### IRS FISCAL YEAR 2009 BUDGET REQUEST

Mr. Chairman, as you know, the IRS budget forms the foundation for what the IRS can provide to taxpayers in terms of customer service and how the agency can best fulfill its tax enforcement mission. Without an adequate budget, the IRS cannot expect to continue providing taxpayers with top quality service and will be hampered in its effort to enhance taxpayer compliance and close the tax gap.

While acknowledging that IRS employees continue to provide world class customer service and are more efficient than ever in collecting taxes and enforcing tax law, the administration continues to put forth insufficient and unrealistic budget requests that fail to allow the service to meet its customer service and enforcement challenges.

Staffing levels are dramatically below 1995 levels.

The decline in IRS personnel, particularly enforcement staff, can be attributed to unrealistic budget requests, which since 2003, have contemplated internally generated savings or "efficiency savings" to help fund proposed increased staffing for

<sup>25</sup> According to IRS officials, before March 3, taxpayers with stimulus-related calls were transferred to an automated message, which told taxpayers that additional information would be forthcoming. IRS estimated that the number of these calls frequently ranged from 20,000 to 60,000 per day. IRS assistants started answering stimulus-related questions on March 3, and IRS established its dedicated telephone line for stimulus-related calls on March 14.

enforcement. For fiscal year 2009, the budget request identifies “efficiency savings” of more than \$94 million at the cost of almost 976 FTEs. If, as sometimes has been the case in previous years, IRS fails to realize all expected savings then the funds available for new enforcement personnel would be further reduced.

And although it’s widely recognized that additional funding for enforcement provides a great return on the investment, the IRS has repeatedly told Congress that the IRS does not need any additional funding above the President’ budget request.

Employee productivity is not the issue. Despite the significant decline in enforcement staff over the past 10 years, enforcement revenue has increased significantly, reaching \$59.2 billion in 2007, up from \$48.7 billion in 2006 and an increase of \$46 billion since 2000. The \$59.2 billion in collections in 2007 represents a 5.6 to 1 return on investment for all IRS activities. In addition, earlier this year the IRS Data Book for 2007 was released which demonstrated that the IRS is one of the most efficient tax collection systems in the world, spending only 40 cents to collect \$100.

Yet, between 1995 and 2007, the total number of employees has shrunk from 114,064 to 86,638. Even more alarming is that during that period, revenue officers and revenue agents—two groups critical to reducing the tax gap—have shrunk by 33 and 20 percent respectively. Revenue officers went from 8,139 to 5,468 and revenue agents fell from 16,078 to 13,026. These drastic cuts have come at a time when the IRS workload has increased dramatically. According to IRS’s own annual reports and data, taxpayers filed 114.6 million returns in 1995. After a steady annual climb, 11 years later, the Service saw 134.4 million returns filed. In addition, between 1997 and 2007, the number of individual tax returns with \$100,000 in reported income, which are generally more complex returns, increased by 103 percent.

Unfortunately, instead of recognizing that the dramatic cuts to the IRS workforce are straining the ability of IRS employees to handle the increasing workload, the IRS has continued to reduce its workforce. Further exacerbating the dire staffing situation at the Service is the aging of the IRS workforce. Approximately 4,000 of its employees are retiring annually presenting the Service with the difficult challenge of replacing a large portion of its workforce each year and the institutional knowledge they take with them. These retirements of some of the Services’ most experienced personnel will only further stress the current IRS workforce already straining under a rising workload.

Amazingly, IRS efforts to reduce the overall workforce have targeted some of the Service’s most productive employees. These include the recent re-organization of the Estate and Gift Tax Program which sought the elimination of 157 of the agency’s 345 estate and gift tax attorneys—almost half of the agency’s estate tax lawyers—who audit some of the wealthiest Americans. The Service pursued this drastic course of action despite internal data showing that estate and gift attorneys are among the most productive enforcement personnel at the IRS, collecting \$2,200 in taxes for each hour of work. It is difficult to understand why the IRS sought the elimination of key workforce positions in an area that could produce significant revenue to the general treasury.

In addition, the Service continues to move forward with its plan to close 5 of its 10 paper tax return submission facilities by 2011. The IRS originally sought the closings of the five paper return submission centers due to the rise in the use of electronic filing (e-filing) and in order to comply with the IRS Restructuring and Reform Act of 1998 (RRA 98) which established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. But the IRS recently reported that in 2007 just 57 percent of Federal tax returns were filed electronically and has previously acknowledged that it is getting harder to convert additional taxpayers to e-filing as those that might convert most readily have already done so.

The continued slow migration of taxpayers to e-filing recently caused the IRS Oversight Board to call on Congress to extend the 80 percent deadline to 2012 in its recent report to Congress on e-filing.

In addition, while the IRS has stated that it will achieve millions of dollars in cost savings as a result of the paper submission consolidation effort, an August 2007 report by the Treasury Inspector General for Tax Administration (TIGTA) found that the agency’s business decision to consolidate sites did not even include a cost-benefit analysis (TIGTA Report Number: 2007–40–165). Furthermore, the report found that the IRS had not adequately updated or monitored financial information on the personnel costs of consolidations and had included savings not attributable to site consolidation in some of its analyses. What is most disturbing is that while the IRS acknowledged some of the assumptions used to determine the consolidation plan may have changed, they refused to complete a cost-benefit analysis to determine if the existing plan is optimal or if alternatives need to be considered.

Mr. Chairman, while overall use of e-filing may be on the rise, it is clear that the number of taxpayers opting to use this type of return is not increasing as rapidly as the IRS had originally projected. Combined with the fact that the IRS consolidation strategy rests on an incomplete business plan which did not include any type of cost-benefit analysis, NTEU believes that the IRS should immediately postpone further site consolidations until a comprehensive cost-benefit analysis can be completed to ensure that the existing plan is optimal in terms of cost savings and benefits.

It is clear that drastic reductions in some of the agency's most productive tax law enforcement employees directly contradict the Service's stated enforcement priority to discourage and deter non-compliance. In addition, we believe these staffing cuts have greatly undermined agency efforts to close the tax gap which the IRS recently estimated at \$345 billion. As Nina Olson, the National Taxpayer Advocate noted, this amounts to a per-taxpayer "surtax" of some \$2,000 per year to subsidize non-compliance. And while the agency has made small inroads and the overall compliance rate through the voluntary compliance system remains high, much more can and should be done. NTEU believes that in order to close the tax gap and handle a rising workload, the IRS needs additional employees on the frontlines of tax compliance and customer service. In addition, we believe Congress should establish a dedicated funding stream to provide adequate resources for those employees.

#### NTEU STAFFING PROPOSAL

In order to address the staffing shortage at the IRS, NTEU believes the workforce should be gradually increased to its pre-1996 levels. Specifically, we support a 3 percent annual net increase in staffing (roughly 2,600 positions per year) over a 5-year period to gradually rebuild the depleted IRS workforce to its pre-1996 levels from its current level of 86,638. Because it takes time and careful management to hire, train, and deploy qualified professional staff, consistent but modest annual increases are necessary. A similar idea was proposed by former IRS Commissioner Charles Rossotti in a 2002 report to the IRS Oversight Board. In the report, Rossotti quantified the workload gap in non-compliance, that is, the number of cases that should have been, but could not be acted upon because of resource limitations. Rossotti pointed out that in the area of known tax debts, assigning additional employees to collection work could bring in roughly \$30 for every \$1 spent. The Rossotti report recognized the importance of increased IRS staffing noting that due to the continued growth in IRS' workload (averaging about 1.5 to 2 percent per year) and the large accumulated increase in work that should be done but could not be, even aggressive productivity growth could not possibly close the compliance gap. Rossotti also recognized that for this approach to work, the budget must provide for a net increase in staffing on a sustained yearly basis and not take a "one time approach."

Adding staff to handle an increasing workload at the IRS is not a new concept. In its 2001 budget request, IRS asked for funding for the Staffing Tax Administration for Balance and Equity program (STABLE), an initiative aimed at restoring IRS staffing to mid-1990s levels and strengthening the Service's tax compliance and customer service functions. The STABLE initiative envisioned hiring nearly 4,000 new employees to help increase compliance and improve customer service. The proposal sought to boost staff in Field Offices, where IRS employees provide direct, in-person service to taxpayers, and Service Center/Call Sites, where service is typically provided via telephone and correspondence. Hiring requirements for the Field Offices was to be determined based on projected workload in the office's geographic area, and existing staff capabilities. Conversely, Service Center/Call Site workload would be planned on a nationwide basis due to the nature of the work, and staffing allocations based upon physical space and local labor market conditions around the center in question.

Although such a staffing initiative would require a substantial financial commitment, the potential for increasing revenues, enhancing compliance and shrinking the tax gap makes it very sound budget policy. One option for funding a new staffing initiative would be to allow the IRS to hire personnel off-budget, or outside of the ordinary budget process. This is not unprecedented. In fact, Congress took exactly the same approach to funding in 1994 when Congress provided funding for the administration's IRS Tax Compliance Initiative which sought the addition of 5,000 compliance positions for the IRS. The initiative was expected to generate in excess of \$9 billion in new revenue over 5 years while spending only about \$2 billion during the same period. Because of the initiative's potential to dramatically increase Federal revenue, spending for the positions was not considered in calculating appropriations that must come within annual caps.

A second option for providing funding to hire additional IRS personnel outside the ordinary budget process could be to allow IRS to retain a small portion of the revenue it collects. The statute that gives the IRS the authority to use private collection companies to collect taxes allows 25 percent of collected revenue to be returned to the companies as payment, thereby circumventing the appropriations process altogether. Clearly, there is nothing magical about revenues collected by private collection companies. If those revenues can be dedicated directly to contract payments, there is no reason some small portion of other revenues collected by the IRS could not be dedicated to funding additional staff positions to strengthen enforcement.

While NTEU agrees with IRS' stated goal of enhancing tax compliance and enforcement, we don't agree with the approach of sacrificing taxpayer service in order to pay for additional compliance efforts. That is why we were disappointed to see that the President's proposed budget calls for a \$31 million cut in funding for Taxpayer Assistance Center (TACs) at a cost of 262 FTEs. NTEU believes providing quality services to taxpayers is an important part of any overall strategy to improve compliance and that reducing the number of employees dedicated to assisting taxpayers meet their obligations will only hurt those efforts. It is clear that IRS employees are continuing to provide quality customer service to American taxpayers. 2007 year end data from the IRS shows that IRS' customer assistance centers met the 82 percent level of service goal, with an accuracy rate of 91 percent for tax law questions. And while these numbers show that employees providing taxpayer services are helping taxpayers understand and meet their tax responsibilities, more can and should be done.

Mr. Chairman, in order to continue to make improvements in taxpayer services while handling a growing workload and increasing collections, it is imperative to reverse the severe cuts in IRS staffing levels and begin providing adequate resources to meet these challenges. With the future workload only expected to continue to rise, the IRS will be under a great deal of pressure to improve customer service standards while simultaneously enforcing the Nation's tax laws. NTEU strongly believes that providing additional staffing resources would permit IRS to meet the rising workload level, stabilize and strengthen tax compliance and customer service programs and allow the Service to address the tax gap in a serious and meaningful way.

#### PRIVATE TAX COLLECTION

Mr. Chairman, as stated previously, if provided the necessary resources, IRS employees have the expertise and knowledge to ensure taxpayers are complying with their tax obligations. That is why NTEU continues to strongly oppose the administration's private tax collection program. NTEU believes this misguided proposal is a waste of taxpayer's dollars, invites overly aggressive collection techniques, jeopardizes the financial privacy of American taxpayers and may ultimately serve to undermine efforts to close the tax gap.

NTEU strongly believes the collection of taxes is an inherently governmental function that should be restricted to properly trained and proficient IRS personnel. When supported with the tools and resources they need to do their jobs, there is no one who is more reliable and who can do the work of the IRS better than IRS employees.

As you know, in September 2006, the IRS began turning over delinquent taxpayer accounts to private collection agencies (PCAs) who are permitted to keep up to 24 percent of the money they collect. NTEU strongly believes the collection of taxes is an inherently governmental function that should be restricted to properly trained and proficient IRS personnel.

NTEU believes this misguided proposal is a waste of taxpayer's dollars, invites overly aggressive collection techniques, jeopardizes the financial privacy of American taxpayers and may ultimately serve to undermine efforts to close the tax gap.

According to the IRS, in fiscal year 2007, the PCAs brought in just \$32 million in gross revenue, far below original projections of up to \$65 million. After deducting commission payments to the PCAs, the true net revenue from PCA (non-IRS) collection activity was just \$20 million. Therefore, after spending \$71 million in start up and ongoing maintenance costs through the end of fiscal year 2007, the IRS private tax collection program lost more than \$50 million.

According to Nina Olson, the National Taxpayer Advocate, the dismal performance of the private collectors is forcing the IRS to downwardly revise its original 10-year projections for the program. For fiscal year 2008, the IRS is now projecting gross revenues of just \$23 million, despite projections as recently as last May indicating the program would bring in up to \$127 million. In addition, despite assurances that the program would recover all start-up and maintenance costs by April



of this year, the IRS is now projecting the program will not break even until late fiscal year 2010.

NTEU also believes that sky high commission payments to the private contractors for work on the easiest to collect cases is unjustified and unnecessary. Under current contracts, private collection firms are eligible to retain 21 percent to 24 percent of what they collect. The legislation authorizing the program actually allows PCAs to retain up to 25 percent of amounts collected. These commission rates were never put up for competition. Before the initial bid solicitations went out, the IRS set commission rates at 21 to 24 percent of the revenue collected by contractors, denying bidders an opportunity to make offers on terms that would have resulted in the IRS getting a greater share of the collected revenue. Consequently, one of the companies that lost its bid for a contract filed a protest with GAO and noted in its bid protest that "offerors were given no credit for proposing lower fees than the 'target' percentages recommended by the IRS."

The problem of excessive commission rates was recently addressed by Congress in legislation overhauling the Department of Education's student loan program, which the IRS has consistently held up as a model for the IRS private collection program. Amid charges that student aid lenders have engaged in abusive and potentially illegal collection tactics including charging excessively high collection fees, coercing consumers into payment plans they could not afford and misrepresenting themselves as Department of Education employees, the House and Senate approved H.R. 2669, the "Higher Education Access Act of 2007," which lowers from 23 percent to 16 percent the amount of recovered money that private guaranty agencies contracted by the Government can retain on defaulted loans.

Mr. Chairman, in addition to being fiscally unsound, the idea of allowing PCAs to collect tax debt on a commission basis also flies in the face of the tenets of the IRS Restructuring and Reform Act of 1998 (RRA 98) which specifically prevents employees or supervisors at the IRS from being evaluated on the amount of collections they bring in. But now, the IRS has agreed to pay PCAs out of their tax collection proceeds, which will clearly encourage overly aggressive tax collection techniques, the exact dynamic the 1998 law sought to avoid.

The fear that allowing PCAs to collect tax debt on a commission basis would lead to contractor abuse was realized when the IRS recently confirmed that the agency had received more than five dozen taxpayer complaints against the PCAs, including violations of the taxpayer privacy laws under Code section 6103. At least one of those complaints was confirmed by an IRS Complaint Panel to be a serious violation of law. In addition, penalties totaling \$10,000 have been imposed by the IRS on the PCAs for taxpayer violations. In one instance, private collectors made 150 calls to the elderly parents of a taxpayer after the collection agency was notified he was no longer at that address. And one of the three private contractors was dropped by the IRS for dubious practices despite the Service's previous assurance that its oversight would prevent abuse.

Mr. Chairman, NTEU is not alone in our opposition to the private tax collection program. Opposition to the IRS tax debt collection program has also been voiced by a growing number of major public interest groups, tax experts, two former IRS Commissioners as well as the National Taxpayer Advocacy Panel, whose members are appointed by the IRS and the Treasury Department. In addition, the National Taxpayer Advocate, an independent official within the IRS previously identified the IRS private tax collection initiative as one of the most serious problems facing taxpayers and recently renewed her prior call for Congress to immediately repeal the IRS' authority to outsource tax collection work to private debt collectors.

Opposition to the program has also been growing within Congress. Since granting IRS the authority to use PCAs in the American Jobs Creation Act of 2004, the House of Representatives, with bi-partisan support, has twice passed language prohibiting the IRS from moving forward with its private collection initiative. In addition, last session, the House overwhelmingly approved two separate tax bills (H.R. 3056, the "Tax Collection Responsibility Act of 2007" & H.R. 3996, the "Temporary Tax Relief Act of 2007") that contain language that would repeal IRS' authority to use private debt collectors to pursue tax debts.

In the Senate, stand alone legislation (S. 335) introduced by Senator Byron Dorgan (D-ND) that would force the IRS to immediately and permanently suspend its plan to outsource part of its tax debt collection responsibilities to PCAs and prohibit the use of any IRS funds for that purpose has 24 co-sponsors.

Mr. Chairman, instead of rushing to privatize tax collection functions which jeopardizes taxpayer information, reduces potential revenue for the Federal Government and undermines efforts to close the tax gap, NTEU believes the IRS should increase compliance staffing levels at the agency to ensure that the collection of taxes is restricted to properly trained and proficient IRS personnel.

The IRS already has a significant collection infrastructure with thousands of trained employees, including 14 Automated Collection System (ACS) sites which allow the IRS to contact taxpayers by telephone and collect delinquent taxes. The ACS function is a critical Collection operation, collecting nearly \$1.49 million per employee per year. The IRS itself has analogized the use of private collectors to the ACS, where IRS collection representatives interact with taxpayers on the telephone. But unlike the private collectors, ACS personnel are able to analyze financial statement information, research assets, enter into installment agreements, make currently not collectible determinations, and can take lien and/or levy enforcement actions. ACS employees also receive training that is far more comprehensive and rigorous than that of the private collectors. In addition, these employees undergo mandatory annual training on topics such as confidentiality and privacy of taxpayer information, ethics awareness, taxpayer rights and computer security.

Unfortunately, inadequate staffing at ACS sites has prevented the IRS from using its current systems to proactively contact taxpayers by telephone to resolve delinquent accounts. The need for the IRS to expand ACS' use of outbound calls has been recognized by IRS management and at least two recent internal IRS study groups have recommended making more outbound calls as a way to make the ACS operation more effective and efficient.

Mr. Chairman, according to the IRS they will spend \$7.65 million to run the private collection program in fiscal year 2008. NTEU believes that instead of continuing to expend valuable IRS resources on this failed program, this \$7.65 million should instead be used to fund roughly 102 additional ACS employees that could return more than \$151 million to the Treasury annually. By comparison, the IRS is now projecting the PCAs to bring in just \$23 million in gross revenue in fiscal year 2008, far less than its original estimate of up to \$127 million.

NTEU believes that increasing the number of ACS personnel would allow the IRS to maximize its ability to proactively resolve delinquent accounts by contacting taxpayers directly. This would also help ensure that the high level of customer service to those taxpayers who call the ACS seeking account resolution is preserved. The IRS has acknowledged that ACS employees are already performing admirably noting that in 2006, ACS customer service and quality ranged between 89.5 to 99.5 percent (pg. 54—IRS response to Olson 2006 Report to Congress). These exceptional ratings are all the more impressive when you consider ACS employees generally work on much more complex and often contentious cases than those being worked by the private collectors and that the total number of cases worked by ACS employees dwarfs those worked by the private collectors.

Mr. Chairman, NTEU understands and commends efforts to ensure that all taxpayers pay their fair share of taxes. Without a doubt, rank and file IRS employees are committed to achieving this goal in the most cost-effective manner while providing a high level of customer service to American taxpayers. But the facts make clear that the use of private tax collection companies is not in the best interest of American taxpayers, could potentially undermine future efforts to close the tax gap, and should be terminated immediately.

A number of other issues important to NTEU members are often addressed in the FSGG Appropriations bill and I would like to address some of them here.

#### PAY RAISE

The Federal Employees Pay Comparability Act (FEPCA), enacted in 1990 to close the gap between Federal and private sector pay, has never been fully implemented. As a result, there is now a 23 percent disparity between Federal employees and their private sector counterparts. Under the President's plan, Federal employees will fall even further behind the private sector.

The administration's budget proposed a 2.9 percent pay raise for Federal workers next year. This not only fails to recognize the important role of our Nation's workforce, it is below the 3.4 percent pay raise the President recommended for the military. The administration's recommendation ignores the essential role of Federal employees in protecting our Nation at the borders, in the domestic and international movement of money, in public health, in nuclear security, and in the collection of revenue among others. Further, it ignores the longstanding principle of pay parity, the recognition that Federal civil servants and their brothers and sisters in the military, work side by side and should receive an equal level of pay increase. Importantly, pay parity was just reaffirmed on March 13, 2008, in House of Representatives when it passed H. Con Res. 312, the fiscal year 2009 budget resolution. I urge the subcommittee to report its bill in keeping with this pay parity principle.

For most of the last 20 years, Government employees in civil service and military personnel have received the same level of pay increase. Last year, both the military

and Federal civil servants received a 3.5 percent pay raise in the final fiscal year 2008 bills. That amounted to the annual raise in the Employment Cost Index (ECI) plus one-half percent, the standard pay figure received in every year of the current administration with the exception of 2007. For 2009, the current raise in the ECI as calculated by the Department of Labor is 3.4 percent, and an extra one-half percent equals 3.9 percent. NTEU urges the subcommittee to follow the precedent of ECI plus one-half percent and report legislation for fiscal year 2009 providing a 3.9 percent raise to Federal employees. We will be working with the appropriate committees to enact a military raise of the same level.

#### *SEC Pay*

NTEU represents the employees of the Securities and Exchange Commission (SEC). We believe that the SEC must be provided with adequate resources to ensure that its performance based pay system can be a viable tool for employee retention and recruitment. While there have been numerous problems with this pay system, adequate funding is essential. From fiscal year 2002 to fiscal year 2005, the SEC budget included a 3 percent increase over current compensation levels to fund the performance pay system. However, for the past 2 years, the SEC's budget has included only a 2 percent increase. This year, the President has only requested a 1.5 percent increase. The continuing performance pay funding crisis has hamstrung SEC managers' ability to provide meaningful and appropriate performance based salary increases to their employees. As budget shortfalls have shifted the system from being fundamentally performance based, some senior managers at the SEC have sent notices to their employees stating that they are being given lower ratings not for performance reasons but because of budgetary limitations. This state of affairs is having severe and negative impacts on employee morale and retention at SEC, contrary to the stated purpose of the performance pay system. NTEU would ask for an additional \$5 million in funding for the SEC for this purpose.

#### OPM PRESCRIPTION DRUG SUBSIDY

Mr. Chairman and members of the subcommittee, it is NTEU's position that OPM should apply for the drug subsidy to which it is entitled under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173). Under this law, which created the Medicare Part D prescription drug program, the Government, as an employer, is eligible to receive a subsidy payment made available to all employers that provide prescription drug benefits as generous as the Medicare program. The "Medicare employer payment" was designed to encourage employers to retain such benefits.

According to GAO, if OPM had applied for the subsidy, it would have lowered the average 2006 FEHBP premium by 2.6 percent. Some of the individual health plans that serve a high number of retirees could have realized a slowdown in premium growth by as much as 3.5 to 4 percent. These savings could have been passed on to keep the enrollee portion of the premium down. Unfortunately, estimates are that OPM has have left more than \$1 billion on the table by forgoing the subsidy. NTEU would support legislative language require OPM to apply for the subsidy, which would help keep FEHBP costs down for millions of Federal employees and their families who are enrolled.

#### CONTRACTING OUT

Another issue pertinent to the subcommittee's jurisdiction is the contracting out of Government positions and responsibilities. I want to commend and thank the subcommittee for incorporating important privatization language in its portion of the fiscal year 2008 Omnibus Appropriations bill to help level the playing field for Federal employees.

Unfortunately, the administration's fiscal year 2009 budget request has called for the repeal of these important provisions. We strongly urge Congress to oppose any efforts to repeal these important provisions that allow Federal employees the ability to fairly compete with the private sector.

In addition, NTEU strongly supports making Government-wide a number of additional contracting out reforms included in the fiscal year 2008 Defense Authorization Bill which currently only apply to the Department of Defense. These include provisions that would encourage "insourcing" by providing employees Government-wide the opportunity to compete for new work or work currently performed by contractors, allow Government employees to acquire new work by allowing agencies to bring work in-house without going through the A-76 process, eliminate the automatic recompensation requirement which previously only applied to Federal employees and not contractor employees, and establishment of a contractor inventory in

every Government agency to track the cost and performance of every service contract to help identify contract work that could be converted to performance by Federal employees.

By making these important contracting out reforms applicable to the entire Federal workforce, Congress can help bring fairness and accountability to the entire competitive sourcing process. NTEU firmly believes that Federal employees are the best value for taxpayers' dollars and they deserve a fair and level playing field on which to demonstrate their effectiveness and efficiency to the White House, Congress, and the American public.

#### CONCLUSION

Mr. Chairman, while Federal workers, and in particular IRS employees, continue to get mixed signals regarding their value to this administration, they remain committed to serving the American public to the best of their abilities. With the expected surge in Federal retirements in the coming years, it is imperative that the Federal Government do all it can to retain the hundreds of thousands of talented public servants who have the knowledge and expertise to continue contributing to the Federal workforce while at the same time preparing to compete for the best and brightest of the young new workers.

Therefore, NTEU believes it is imperative that the administration reverse many of its policies that have devalued the role of Federal employees and the work that they do including the failure to pay competitive salaries and the constant focus on downsizing and outsourcing. These misguided policies have reduced morale of Federal employees Government-wide and have put the Federal Government at a disadvantage when it comes to attracting, developing and retaining qualified employees.

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#### PREPARED STATEMENT OF OMB WATCH

OMB Watch would like to submit the report, "Bridging the Tax Gap: The Case for Increasing the IRS Budget," into the record for the Committee on Appropriations Subcommittee on Financial Services and General Government hearing on the IRS fiscal year 2009 budget on April 16, 2008.

OMB Watch supports efforts by the IRS to close the so-called "tax gap," and believes increased funding of the IRS budget is a necessary condition to achieving this goal. The \$4.6 billion appropriated to the IRS's enforcement budget in fiscal year 2008 is less than the 1995 IRS enforcement budget (in inflation-adjusted terms). As the enforcement budget was cut, the IRS saw the number of tax returns filed increase 11 percent from 205 million in 1995 to 228 million in 2006 (the last year for which such data are available).

In addition to the amount of resources available to the IRS, also of concern are the means by which the IRS enforces tax laws. The use of private tax collectors not only exposes taxpayer data to private firms, but when compared to Federal tax collectors, private collectors are extremely inefficient. Use of Federal employees for tax collection results in a 13:1 return-on-investment (ROI) ratio (\$13 collected for each dollar spent), while private tax collectors achieve an ROI of 4.5:1. That the IRS would continue this program represents an egregious mismanagement of tax collection resources.

OMB Watch also believes better targeting of audits and the types of audits performed would enhance the IRS's ability to close the tax gap. Although the overall audit rate has seen a slight increase in recent years (a positive development, to be sure), that increase has been largely constituted of increases in correspondence audits. Compared to face-to-face audits, correspondence audits result in lower revenue yields. Whereas correspondence audits of individuals earning over \$100,000 per year result in about a \$32,000 increase in identified tax liability, face-to-face audits yield, on average, about \$55,000.

Additionally, the IRS has been spending too much time auditing low-income Americans. Forty percent of all audits performed in 2006 were of taxpayers claiming the EITC, resulting in a 2.25 percent audit rate for EITC claimants—more than double the 1 percent rate for all taxpayers. With an average yield of \$2,895, EITC-return audits have the lowest rate of return of any audit conducted by the IRS. That so many IRS resources are devoted to these low-yield audits underscore the depth of inefficient enforcement practices.

Instead of employing this punitive approach to closing the tax gap through EITC compliance, the IRS should increase resources devoted Taxpayer Assistance Centers (TAC) to increase EITC return accuracy. TAC-prepared EITC returns reduce overpayments by \$640–\$1,300. However, the number of TAC-prepared returns have

been declining as TACs experience staffing shortages. By increasing resources devoted to TACs, the IRS would not only reduce the tax gap, but would expand much-needed services to low-income taxpayers.

These important tax enforcement issues, and others, are explored in greater detail the report we are submitting. We hope this will help raise awareness of the importance of addressing enforcement issues at the IRS and that the committee will use the findings of this report in formulating IRS legislation.

JANUARY 2008.

## BRIDGING THE TAX GAP—THE CASE FOR INCREASING THE IRS BUDGET

### ACKNOWLEDGEMENTS

Matt Lewis, a Federal Fiscal Policy Analyst, conducted the primary research and writing of this report, with assistance from Adam Hughes, Director of Federal Fiscal Policy. Other OMB Watch staff provided advice and research support. Brian Gumm, Communications Coordinator, provided editorial support and designed the report.

OMB Watch is a nonprofit research and advocacy organization whose core mission is increasing Government accountability and improving citizen participation. Responsible, fair, and equitable budget and tax policy has been an important part of our work for more than 20 years, and we have practical experience in promoting and informing the public on budget and tax legislation and regulations.

This report is available electronically at: <http://www.ombwatch.org/budget/irstaxgap2008.pdf>.

### INTRODUCTION

A significant and pernicious problem facing the Nation is the tax gap, the difference between what is owed in taxes and what is paid. Estimated to be over \$300 billion annually, the tax gap represents an enormous revenue loss for the Government. This lack of revenue often causes unnecessary increases in annual deficits and the national debt, increasing national interest payments and adding pressure to cut vital Government services. Unfortunately, much of the gap must be made up eventually by honest taxpayers through higher taxes and by beneficiaries of Federal investments through service cuts.

The Internal Revenue Service (IRS) is responsible for enforcing tax laws and collecting taxes, and therefore, it has the greatest capacity and responsibility to reduce the tax gap. The extent to which the IRS can influence the tax gap is mostly a product of the resources and powers lawmakers in Congress provide the agency and how well IRS administers those resources and powers.<sup>1</sup>

Congress has given considerable lip service to doing something about the tax gap for years but has done little to actually give the IRS the tools to make significant progress in closing it. Despite this fact, Congress has demanded the IRS close the tax gap without making more resources available for the agency to do so. Thus, the IRS has been forced to make difficult choices as to how to use the limited resources it has been allocated. As a result, at the very least, the tax gap remains a large problem, and most experts believe it has probably increased in size as the IRS has largely scaled back tax law enforcement over the last 10 years.

The IRS can reduce the size of the tax gap—progress that would yield billions in additional revenue each year. In order to accomplish this, Congress and the IRS will need to invest more in three areas of the IRS budget: audits, collections, and tax preparation services for low-income taxpayers eligible for the Earned Income Tax Credit. With sufficient resources, the IRS should be able to implement effective and efficient tax enforcement policies and programs that will have a real impact on reducing the tax gap.

### THE \$300 BILLION PROBLEM: THE TAX GAP

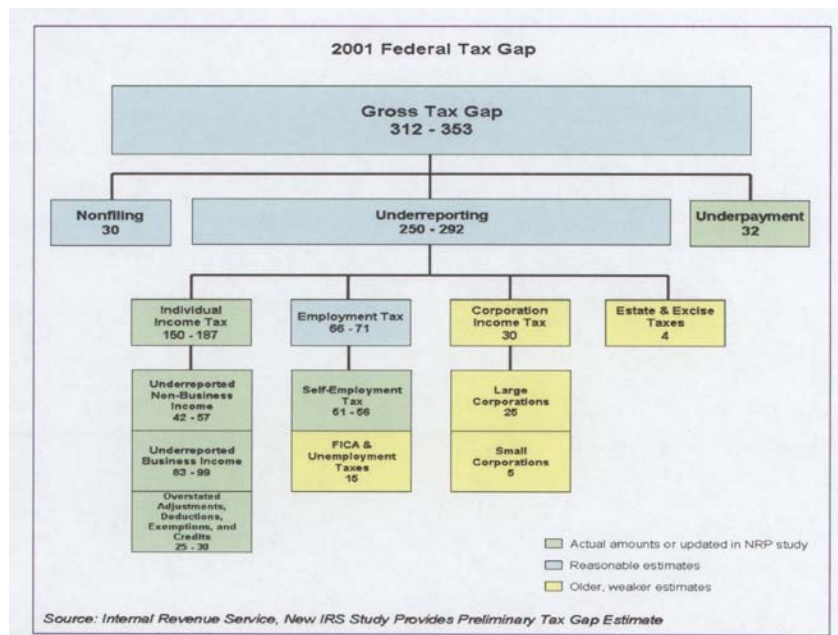
IRS defines the tax gap in two ways. The gross tax gap is the total amount of taxes that were not paid when tax returns were first filed, while the net tax gap consists of taxes that are not paid after the IRS takes steps to enforce tax laws. The most recent data on the gross tax gap comes from the IRS National Research Project, which evaluated tax returns from fiscal year 2000. It put the gross tax gap at between \$312 billion and \$353 billion annually, or about 16 percent of all taxes owed. Although the percentage of the economy the tax gap represents has not

<sup>1</sup>Significant changes to tax laws have reduced the IRS's influence over tax enforcement, and many proposals have been made to increase tax compliance with authorizing legislation. For one in-depth overview, see Max Sawicky's *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (Washington, DC: Economic Policy Institute, 2005).

changed significantly, the absolute size of the gross tax gap has in all likelihood grown in step with the economy.<sup>2</sup> Most of the tax gap results from taxpayers under-reporting their income.

It is unclear, however, how much the tax gap has increased as a percentage of the total amount of taxes owed. In the last two decades, IRS has only measured the tax gap three times. Each time, it found the tax gap represented between 16 and 20 percent of total revenues owed.<sup>3</sup> On the other hand, anecdotal evidence, particularly the work of Pulitzer Prize-winning journalist David Cay Johnston, suggests the tax gap has grown as wealthier taxpayers have responded to and requested reductions in the IRS enforcement presence.

In any case, the IRS can influence both the net and the gross tax gap by encouraging and requiring tax compliance. The IRS recovered \$48.7 billion of the tax gap in fiscal year 2006, which, coupled with late payments, brought the net tax gap to between \$257 billion and \$298 billion.<sup>4</sup> Enforcement efforts also have a strong impact on the gross tax gap, because voluntary compliance tends to increase when enforcement programs are more active. More enforcement increases the fear of being audited and perhaps heightens the public sense of civic responsibility, both of which are thought to promote voluntary compliance. But the exact extent of the impact is subject to debate. Some studies have found the increase in voluntary compliance is many times greater than the money the IRS directly recovers through enforcement programs.<sup>5</sup>



#### IMPACT OF THE TAX GAP

The tax gap affects the public in two ways. Mainly, it reduces what compliant taxpayers already have. Because this revenue is intended to be collected and used by the Government, not collecting it makes implementing Government services and in-

<sup>2</sup>Internal Revenue Service, "New IRS Study Provides Preliminary Tax Gap Estimate," <http://www.irs.gov/newsroom/article/0,,id=137247,00.html> (accessed October 10, 2007).

<sup>3</sup>Eric Toder, "Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction," Urban-Brookings Tax Policy Center, [http://www.taxpolicycenter.org/UploadedPDF/411496\\_reducing\\_tax\\_gap.pdf](http://www.taxpolicycenter.org/UploadedPDF/411496_reducing_tax_gap.pdf) (accessed October 10, 2007).

<sup>4</sup>Internal Revenue Service, "IRS Enforcement Activities Continue To Recover," [http://www.irs.gov/pub/newsroom/11-06\\_stat\\_charts.pdf](http://www.irs.gov/pub/newsroom/11-06_stat_charts.pdf) (accessed October 10, 2007).

<sup>5</sup>Eric Toder, "Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction," Urban-Brookings Tax Policy Center, [http://www.taxpolicycenter.org/UploadedPDF/411496\\_reducing\\_tax\\_gap.pdf](http://www.taxpolicycenter.org/UploadedPDF/411496_reducing_tax_gap.pdf) (accessed October 10, 2007).

vestments more difficult. The existence of the tax gap is kind of like a recurring and permanent tax cut, in the sense it generally must be paid for by either shifting the tax burden to others (in this case, compliant taxpayers), curtailing Government services, or increasing debt. The IRS National Taxpayer Advocate (NTA), for example, has testified before Congress that unpaid taxes shift the tax burden onto compliant taxpayers. If all compliant taxpayers were to assume an equal portion of the tax gap, it would add \$2,200 to their annual tax bills.<sup>6</sup> Looked at another way, if the IRS eliminated the tax gap, Americans could receive the same level of services and programs while paying significantly less in taxes. The actual impact of the tax gap on the taxes paid by each individual most likely depends on personal circumstances and future policy decisions.

But unlike a tax cut, the tax gap creates a patently perverse set of winners and losers—taxpayers who do not follow the law benefit and taxpayers who do lose out. Larger burdens also tend to fall on lower-and middle-income taxpayers, whose compliance rates are higher than other income levels. Higher-income taxpayers, small business owners, and corporations are the main beneficiaries, as their compliance rates are lower. Because of this, on the whole, the tax gap makes the tax code less progressive than the statutory structure indicates, though by exactly how much has not been quantified.<sup>7</sup>

Secondly, and perhaps more importantly, the tax gap reduces what the public could have. The tax gap deprives the Government of more revenue to finance the expansion of Government services and investments, a reduction in the annual deficit, or payments to reduce the national debt. If the tax gap were reduced or eliminated, the additional revenue brought into the Government would, in most circumstances, make the tax code much more progressive. There are surely many different proposals about how to invest the revenue owed, but regardless of how the \$300 billion would be used, the Federal Government is never afforded the opportunity to decide.

On a less practical, but equally important level, the tax gap also represents the eroding integrity of the tax system and could reduce public support for the Federal Government. Such a large amount of unpaid taxes makes the tax system appear ineffective and unfair, since the tax gap regressively favors wealthier people and businesses who have the means to avoid and evade tax law. These perceptions of unfairness in the tax system may have large-scale effects on public policy, undermining public confidence in Government as a fiscal manager.<sup>8</sup> Compliant taxpayers may also object to tax increases on the grounds they would be paid arbitrarily and regressively, and, as a corollary, new Government services or investments financed by tax increases may receive less support. Taxpayers may also view ineffective tax enforcement as indicative of Government incompetence generally and, therefore, oppose expansion of the Government's role. Too many citizens may see no option but to favor tax cuts as a way to restore the integrity of revenue collection and protect themselves from bearing unjust burdens as compliant taxpayers.

#### A PRIMARY CAUSE: LACK OF RESOURCES AT THE IRS

While it is widely established that increased resources at the IRS could help to reduce the tax gap, IRS funding levels have not kept up with growing demands on its budget. The total IRS budget has remained static after adjusting for inflation since the mid-1990s. The funding decline has been most pronounced in the enforcement account of the IRS budget, which includes funding for tax return examinations, tax collections, and document matching services that compare financial records with tax returns. In fiscal year 1995, IRS had \$4.43 billion in its enforcement account. By fiscal year 2006, this budget had only risen to \$4.65 billion—less than a 5 percent increase. During the same period:

—Inflation had eroded the value of this funding by 36 percent;<sup>9</sup>

<sup>6</sup>National Taxpayer Advocate, "National Taxpayer Advocate's 2006 Annual Report To Congress," Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=165806,00.html> (accessed October 10, 2007).

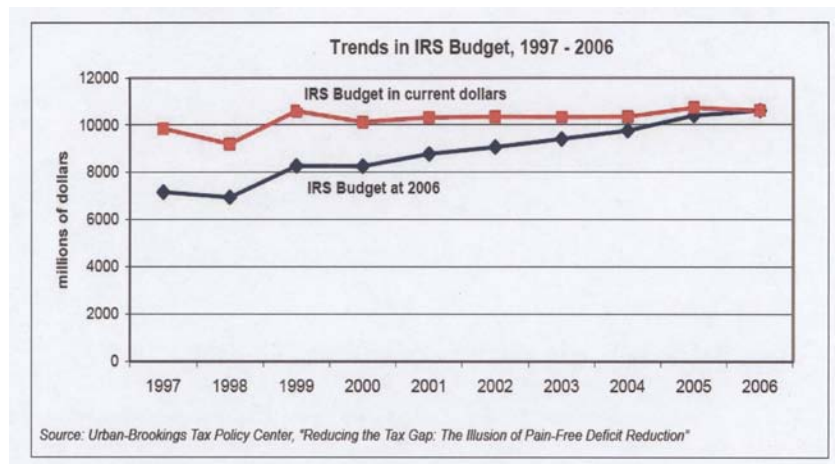
<sup>7</sup>Jason Furman, Lawrence H. Summers, and Jason Bordoff, "Achieving Progressive Tax Reform in an Increasingly Global Economy," Brookings Institution, [http://www3.brookings.edu/views/papers/furman/200706bordoff\\_summers.pdf](http://www3.brookings.edu/views/papers/furman/200706bordoff_summers.pdf) (accessed October 10, 2007).

<sup>8</sup>Alison Kladec and Will Friedman, "Understanding Public Attitudes about the Federal Budget: A Report on Focus Groups," Public Agenda, [http://www.publicagenda.org/research/pdfs/understanding\\_public\\_attitudes\\_about\\_the\\_federal\\_budget.pdf](http://www.publicagenda.org/research/pdfs/understanding_public_attitudes_about_the_federal_budget.pdf) (accessed October 10, 2007).

<sup>9</sup>Bureau of Labor Statistics, "Inflation Calculator," U.S. Department of Labor, <http://www.bls.gov/cpi/> (accessed October 10, 2007).

- The size of the economy grew 42 percent;<sup>10</sup>
- The number of tax returns the IRS processed increased 11 percent, from 205 million to 228 million;<sup>11</sup> and
- Hundreds of changes to the IRS's authority and tax laws gave the agency more work.<sup>12</sup>

Experts inside and outside Government have recognized the resource problem at IRS. IRS National Taxpayer Advocate Nina Olson, who operates independent of the IRS, believes funding shortages have become so problematic, she has called for the creation of special rules for IRS budget bills. Charles Rossotti, former commissioner of the IRS, told the IRS Oversight Board in 2002 that much of the tax gap is a result of the failure of Congress to provide enough resources for tax law administration:



The source of this problem are two conflicting, long-term trends: one, ever increasing demands on the tax administration system due to rapid growth in the size and complexity of the economy; and two, a steady decline in IRS resources due to budget constraints. The cumulative effect of these conflicting trends over a 10-year period has been to create a huge gap between the number of taxpayers who are not filing, not reporting or not paying what they owe, and the IRS' capacity to require them to comply.

The resources crunch can be seen more apparently in staffing levels: the number of IRS employees is down sharply from 10 years ago. Between 1995 and 2006, the total number of IRS employees shrunk 18 percent—falling from 114,000 to less than 92,000. The number of revenue agents and officers—IRS employees who perform audits—has decreased even faster, by 40 and 30 percent, respectively.<sup>13</sup> Those categories of employees have decreased from 8,139 to 5,665 for revenue agents and 16,078 and 12,859 for revenue officers.<sup>14</sup> Fewer staff at the IRS has a direct impact on the auditing function at the agency.

There have been many experts who have called for increased funding for the IRS, including the Treasury Inspector General for Tax Administration,<sup>15</sup> the Government Accountability Office,<sup>16</sup> the IRS Oversight Board, Max Sawicky, then of the Eco-

<sup>10</sup> Bureau of Economic Analysis, "National Economic Accounts" U.S. Department of Commerce, <http://www.bea.gov/national/index.htm#gdp> (accessed October 10, 2007).

<sup>11</sup> Internal Revenue Service, "SOI Tax Stats—IRS Data Books," <http://www.irs.gov/taxstats/article/0,,id=102174,00.html> (accessed October 10, 2007).

<sup>12</sup> Charles O. Rossotti, "Report to the IRS Oversight Board: Assessment of the IRS and Tax System," <http://nteuirwatch.org/documents/numbers/Rossotti%2002%20report%20to%20oversight%20board.pdf> (accessed October 10, 2007).

<sup>13</sup> Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

<sup>14</sup> Ibid.

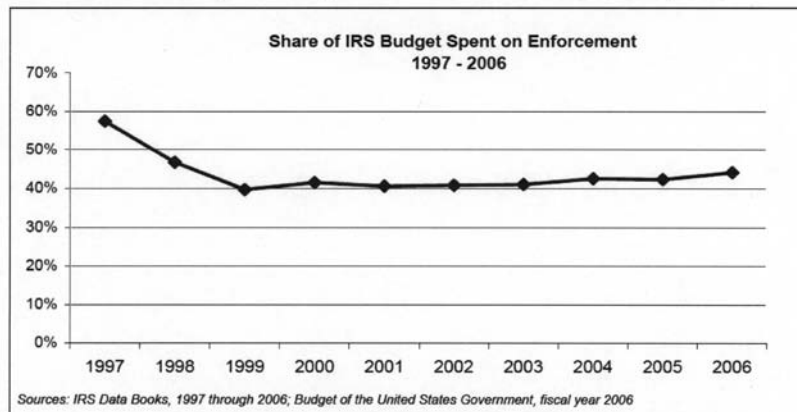
<sup>15</sup> Treasury Inspector General for Tax Administration, "Trends In Compliance Activities Through Fiscal Year 2006," U.S. Department of the Treasury, <http://www.treas.gov/tigta/auditreports/2007reports/200730056fr.html> (accessed October 10, 2007).

<sup>16</sup> Michael Brostek, "Tax Compliance: Multiple Approaches Are Needed To Reduce The Tax Gap," Government Accountability Office, <http://www.gao.gov/new.items/d07488t.pdf> (accessed October 10, 2007).



nomic Policy Institute,<sup>17</sup> Robert McIntyre of Citizens for Tax Justice,<sup>18</sup> Eric Toder of the Urban-Brookings Tax Policy Center,<sup>19</sup> and former IRS Commissioner Donald C. Alexander.<sup>20</sup>

IRS needs additional funding to fulfill its mission as the guarantor of tax compliance. Where funding is needed most is in the IRS enforcement budget, particularly for audits of high-income taxpayers and corporations, the collection function, and services for low-income taxpayers who receive the Earned Income Tax Credit (EITC).



#### INCREASES RESOURCES FOR AUDITS

One of the most disturbing trends in enforcement policy over the last 10 years has been a sharp decline in audits, which are an essential tool in the fight against unpaid taxes. Most of the gross tax gap—between \$250 and \$260 billion—results from individuals and businesses underreporting their income. The IRS determines who inaccurately reported their income and how much they owe in taxes through a variety of means. Examinations, or audits, are one way the IRS makes this determination. In fiscal year 2006, IRS audits showed that an additional \$43.95 billion was owed on all tax returns that were audited.<sup>21</sup> The IRS performed 1.4 million audits, resulting in an audit coverage rate of 0.8 audits per 100 tax returns, or less than 1 percent.<sup>22</sup>

In the last decade, there has been a general decline in most types of audits. In fiscal year 1996, the audit rate for all individual income tax returns was 1.67 percent.<sup>23</sup> In fiscal year 2006, the rate had dropped to 1 percent of all individuals, after reaching a low of 0.5 percent in 2000.<sup>24</sup> The recent upswing in audits is encouraging, but the rate is still far below earlier levels and even farther below historic and adequate levels, according to tax administration experts.<sup>25</sup>

Making things worse, the general decrease in audits has been unequally distributed by taxpayer income with audits of higher-income earners falling faster than the overall decrease. The decline in audits has been the steepest among taxpayers

<sup>17</sup> Max Sawicky, "Do-it-yourself tax cuts: The crisis in U.S. tax enforcement" in *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (Washington, DC: Economic Policy Institute, 2005).

<sup>18</sup> Robert McIntyre, "Statement of Robert S. McIntyre Before the Senate Budget Committee, January 23, 2007," Senate Budget Committee, [http://budget.senate.gov/democratic/testimony/2007/McIntyre\\_TaxGap012307.pdf](http://budget.senate.gov/democratic/testimony/2007/McIntyre_TaxGap012307.pdf) (accessed October 10, 2007).

<sup>19</sup> Eric Toder, "Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction," Urban-Brookings Tax Policy Center, [http://www.taxpolicycenter.org/UploadedPDF/411496\\_reducing\\_tax\\_gap.pdf](http://www.taxpolicycenter.org/UploadedPDF/411496_reducing_tax_gap.pdf) (accessed October 10, 2007).

<sup>20</sup> Max Sawicky, "Interview: Former IRS Commissioner Donald C. Alexander" in *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (Washington, DC: Economic Policy Institute, 2005) 52.

<sup>21</sup> Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

<sup>22</sup> Ibid.

<sup>23</sup> Government Accountability Office, "Tax Administration: Audit Trends and Results for Individual Taxpayers," <http://www.gao.gov/archive/1996/gg96091.pdf> (accessed October 16, 2007).

<sup>24</sup> Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

<sup>25</sup> Sawicky, "Interview: Former IRS Commissioner Sheldon S. Cohen," 25.

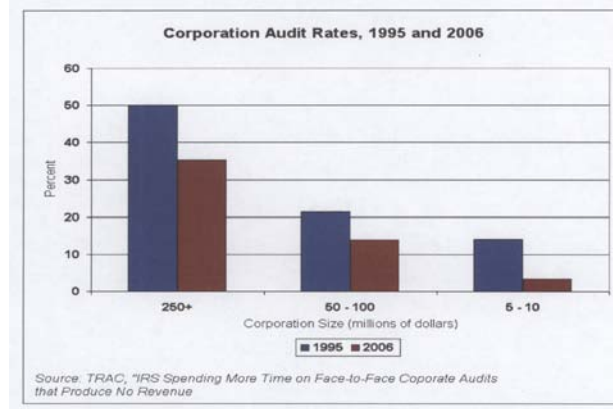
reporting an income over \$100,000. Audits of these filers have dropped from 2.85 percent in fiscal year 1996 to 1.3 percent in fiscal year 2006. Decreases in these audits before 1996 were even more drastic: in fiscal year 1992, higher-income filers were audited 5.28 percent of the time.

Furthermore, business income has been insufficiently audited. Business income, which is reported on individual income tax returns, has been audited at a relatively steady rate since fiscal year 1995. Nevertheless, more audits are needed, as the IRS National Research Project identified the underreporting of income by small businesses as the category that contributed the most to the tax gap, accounting for more than \$109 billion in unpaid taxes annually. \$68 billion of these unpaid taxes are owed by self-proprietorships, known more commonly as the self-employed, and another \$22 billion came from partnerships, S corporations, estates, and trusts. In order to close the tax gap, the IRS will need the necessary resources to expand its investigation and enforcement of tax laws related to these returns, not hold them steady.

#### *Decline in Quality and Quantity of Corporate Audits*

Individual taxpayers are not alone in experiencing a decrease in the likelihood of being audited. Audits related to the corporate income tax for all sizes of corporations have declined significantly. The overall corporate audit rate has been cut in half, dropping from 2.4 percent in 1996 to 1.2 percent in 2006.<sup>26</sup> What's more, new data from the last 5 years obtained by the Transactional Records Access Clearinghouse (TRAC) show that the quality of those audits has also suffered.

Disturbingly, the decline has been most pronounced among the largest corporations. Audits of corporations with assets between \$5 and \$10 million dropped from 14 percent in fiscal year 1995 to 3.4 percent in fiscal year 2006—a 70 percent drop.<sup>27</sup> Slightly larger corporations—with assets of \$50 million to \$100 million—were audited at a rate of 13.8 percent in fiscal year 2006, down from 21.3 percent in fiscal year 1996—a 35 percent decline. Audits of the largest corporations, those with assets of \$250 million or more, have declined by almost a third, from 50 percent in fiscal year 1995 to 35.2 percent in fiscal year 2006.<sup>28</sup> While companies with over \$250 million in assets are small in number—they filed only 0.2 percent of corporate tax returns in 2002—they accounted for a staggering 90 percent of all corporate assets and 87 percent of all corporate income during that year.<sup>29</sup> The decrease in audits among these corporate tax filers must be reversed.



Audits of the largest corporations inexplicably vary by sector, which seems to be an inefficient method of tax enforcement. In fiscal year 2006, only 15 percent of fi-

<sup>26</sup> Transactional Records Access Clearinghouse, "IRS Spending More Time on Face-to-Face Corporate Audits that Produce No Revenue," Syracuse University, <http://trac.syr.edu/tracirs/newfindings/current/> (accessed October 16, 2007).

<sup>27</sup> Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

<sup>28</sup> Transactional Records Access Clearinghouse, "IRS Spending More Time on Face-to-Face Corporate Audits that Produce No Revenue."

<sup>29</sup> Transactional Records Access Clearinghouse, "Relatively Few Corporations Have Most Income and Assets," Syracuse University, <http://trac.syr.edu/tracirs/trends/v10/corpassets.html> (accessed October 17, 2007).

nancial services corporations were audited, compared to 100 percent of all large manufacturing and transportation corporations.<sup>30</sup> Yet companies in the financial sector make up a large part of the economy. The largest corporations in the financial sector account for 25 percent of total receipts of large corporations and over 62 percent of total net income—more than 2.5 times the next highest sector.<sup>31</sup>

What's more unfortunate, however, is that the audits that have been done for corporate filers have been increasingly unproductive, particularly among face-to-face corporate audits—the most thorough and intense audits the IRS conducts. The number of nonproductive auditing hours, which is defined by the IRS as face-to-face examination hours that produce a “no change” result in the amount of tax owed, has increased for every corporate asset class over the last 5 years.<sup>32</sup> The average increase in unproductive hours across all corporate asset classes between fiscal year 2001 and fiscal year 2006 was 40 percent. If the IRS audited a high percentage of corporations, a rise in unproductive hours could be interpreted as a good thing, with companies increasingly paying the taxes they owe. However, because the IRS audits too few corporations and because the tax gap points to large amounts of taxes not being collected, a rise in unproductive hours shows the IRS is being inefficient in selecting which corporations it chooses to audit—a waste of valuable enforcement resources and a missed opportunity to collect more tax revenues.

The rise in unproductive auditing hours increased at faster rates as the size of the corporation increased, especially for large corporations (those with assets over \$10 million). While all four asset classes over \$10 million saw increases in unproductive hours well above the average of 40 percent, as the asset class grows larger, the increases are even more pronounced. At the low end, audits of corporations between \$10 million and \$50 million saw a 61 percent increase in unproductive hours, while audits of corporations above \$250 million in assets saw the largest increases, at 109 percent—more than double the rate from 5 years earlier.<sup>33</sup>

Another alarming trend is the decrease in the number of hours spent per corporate audit. In the last 5 years, every corporate asset class except one (\$10–\$50 million) has seen double-digit decreases in the average length of audits, with the average corporate audit lasting 21 fewer hours.<sup>34</sup> This represents almost a 10 percent drop in the length of corporate audits.

IRS data on corporate audits, combined with the new data obtained by TRAC on audit length, depict disturbing trends in both the quality and quantity of corporate audits—particularly those of the largest corporations. Not only is the IRS performing fewer corporate audits overall than it did 10 years ago, the ones they do perform are done too quickly and are poorly targeted. Due to the size and complexity of the business transactions of large corporations, those returns are likely to produce more reporting errors, and therefore, the IRS should be auditing more of those companies (not less) and spending more time (not less) on each audit.

There have been a few reports that some of the changes within the corporate auditing section (the Large and Mid-Sized Business Division) have been forced on IRS auditors by senior level managers at the IRS. These changes put a strong focus on completing more audits by pre-set deadlines in order to drive up total audit numbers regardless of the quality of the audit or of auditors' opinions about possible serious tax violations they had not had time to investigate during audits. David Cay Johnston reported in *The New York Times* on March 20, 2007, that almost two dozen revenue agents had been pressured by their managers to close open audits too soon—actions the auditors said could cost the Government billions of dollars in unpaid taxes.<sup>35</sup>

This phenomenon was recognized by Colleen Kelley, President of the National Treasury Employees Union, in testimony before the House Appropriations Committee on Financial Services and General Government. Kelley testified the pressure

<sup>30</sup>Transactional Records Access Clearinghouse, “Corporate Audit Rates—Wide Disparities Found for Different Industries,” Syracuse University, <http://trac.syr.edu/tracirs/latest/127/> (accessed October 16, 2007).

<sup>31</sup>Transactional Records Access Clearinghouse, “Net Income of Largest Corporations,” Syracuse University, <http://trac.syr.edu/tracirs/trends/v10/netincsecG.html> (accessed October 16, 2007).

<sup>32</sup>Transactional Records Access Clearinghouse, “Net Income of Largest Corporations.”

<sup>33</sup>Transactional Records Access Clearinghouse, “IRS Corporate Audit Hours Spent on Non-productive Examinations Increasing,” Syracuse University, <http://trac.syr.edu/tracirs/trends/v12/audittimechange.html> (accessed October 16, 2007).

<sup>34</sup>Transactional Records Access Clearinghouse, “Change in Average Audit Length Fiscal Year 2001 vs Fiscal Year 2006,” Syracuse University, <http://trac.syr.edu/tracirs/trends/v12/auditlengthchange.html> (accessed October 16, 2007).

<sup>35</sup>David Cay Johnston, “IRS Agents Feel Pressed To End Cases,” *New York Times*, March 20, 2007. <http://www.nytimes.com/2007/03/20/business/20tax.html>.

put on IRS auditors was not a recent occurrence but had been happening since 2002. Kelley believes it was the result of a new IRS policy called Limited Focused Examination (LIFE) and said the union had heard directly from its members that the policy was undermining both efforts to make sure companies were paying all the taxes they owed and employee morale at the IRS.<sup>36</sup>

The combination of a decrease in overall corporate audit rates, and reports that those audits being done are closed too soon, will encourage tax evasion behavior among corporations, which may have more cause to believe they will not be audited, and that audits themselves are not to be feared.

*Wrong Strategy: Relying on Correspondence Audits*

As far as reducing the tax gap is concerned, the type of audit being administered is equally, if not more important than who is being audited. There are two types of audits: a traditional face-to-face audit, which can happen inside an IRS office or at a taxpayer's home or business, and a correspondence audit. Traditional face-to-face audits involve comprehensive reviews of assets and records, requiring more time and effort for both the taxpayer and the IRS. Correspondence audits consist of the IRS sending a letter to a non-compliant taxpayer in which he or she is asked a few questions about his or her tax return. Striking the right balance between these two types of audits is essential to effective tax enforcement.

Face-to-face audits typically generate far more revenue than correspondence audits, and ones on high-income earners in particular produce the highest yields. In fiscal year 2006, face-to-face audits of high-income earners generated an average of \$54,934.<sup>37</sup> Face-to-face audits on individuals earning between \$50,000 and \$100,000, in contrast, only averaged a \$3,877 yield, yet these taxpayers were audited almost as much (0.23 percent) as their higher-income counterparts (0.44 percent).<sup>38</sup> Even face-to-face audits on returns with business income over \$100,000 yielded less than half as much (\$25,787) as audits of high-income filers.<sup>39</sup> The high yields on face-to-face audits of high-income filers show both that they are a good investment and also that there are significantly more taxes due among those filers.

Despite the high yields of these audits, the IRS is performing them too rarely. IRS administered face-to-face audits for 0.44 percent of all high-income filers in fiscal year 2006, compared to 2.9 percent in fiscal year 1992 and 1.7 percent in fiscal year 1996.<sup>40</sup> Yet the IRS claims, and rightly so, that overall audit rates have been gradually increasing in the last few years. These additional audits have increased the yield on tax enforcement, from a 10-year low of \$32.9 billion in fiscal year 1999 to \$48.7 billion in fiscal year 2006.

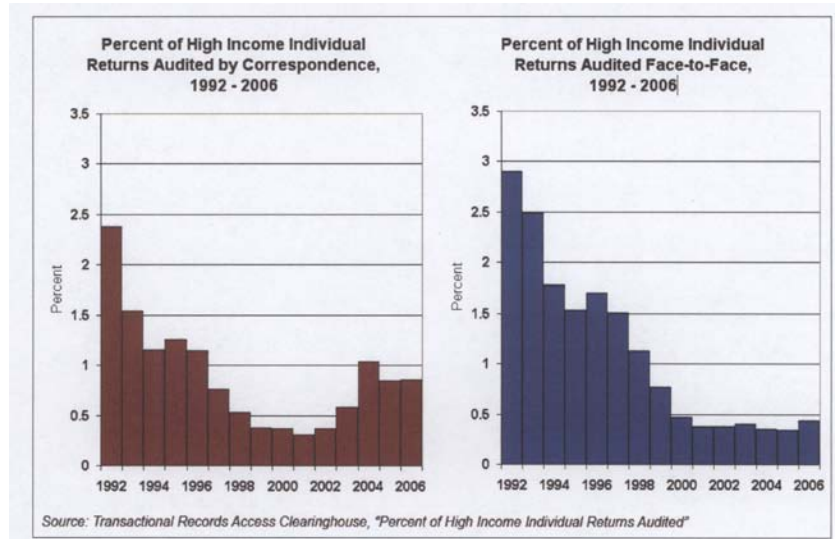
<sup>36</sup> Colleen Kelley, "Statement of Colleen Kelley, National President, National Treasury Employees Union on 'Internal Revenue Service Budget fiscal year 2008,'" National Treasury Employees Union, <http://nteuirswatch.org/documents/numbers/CMK%20Testimony%20to%20House%20FServices%20sub%203-29-07.pdf> (accessed October 18, 2007).

<sup>37</sup> Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

<sup>38</sup> Ibid.

<sup>39</sup> Ibid.

<sup>40</sup> Transactional Records Access Clearinghouse, "IRS 'Face-to-Face' Audits of Federal Income Tax Returns Filed by Individuals," Syracuse University, [http://trac.syr.edu/tracirs/highlights/current/audpctcompare\\_ind.html](http://trac.syr.edu/tracirs/highlights/current/audpctcompare_ind.html) (accessed October 16, 2007).



Unfortunately, the details behind the IRS data on increased audits tell a different story. Much of the increase cited by the IRS has been due to an emphasis on correspondence audits, not the more effective face-to-face audits. Overall, in fiscal year 2006, 77 percent of all audits—more than three out of four—were by correspondence.<sup>41</sup> What's more, correspondence audits—not face-to-face audits—have accounted for 74 percent of the recent increase in audits among high-income individuals.<sup>42</sup> Face-to-face audit levels have increased only modestly over that time.

This trend is problematic because correspondence audits are less effective than face-to-face audits, partly because this type of audit can only spot problems that are evident from information submitted by the taxpayer or from information reported by third parties (employers, banks, and other sources). For comparison, in fiscal year 2006, face-to-face audits on individual income tax returns for earners over \$100,000 yielded an average of \$54,934, while correspondence audits brought in \$31,912.<sup>43</sup> For other types of tax returns, such as large corporations, the difference was even more dramatic. The average yield of a face-to-face audit for large corporations in fiscal year 2006 was \$2.6 million, but correspondence audits of similarly sized companies averaged a meager return of \$285,000.<sup>44</sup>

The IRS seems to have chosen to use correspondence audits so much mainly because administering them requires less staff time and resources. In fiscal year 2006, correspondence audits took an average of only 1.4 auditor hours each, drastically lower than the hundreds of hours face-to-face audits can take.<sup>45</sup> Indeed, IRS data shows even as overall audit rates have increased in the last few years, few additional staff have been added.

The IRS has decided, perhaps because of limited resources, to shift to less efficient and effective processes for auditing. If Congress and others in Government are serious about creating a robust tax enforcement system and closing the tax gap, additional resources are crucial. Increased funds could be used to raise staffing levels enough that IRS may gradually perform more high-yield face-to-face audits, which would have a greater impact on reducing the tax gap.

<sup>41</sup> Transactional Records Access Clearinghouse, "Targeting of Correspondence Audit Improves," Syracuse University, <http://trac.syr.edu/tracirs/newfindings/current> (accessed October 16, 2007).

<sup>42</sup> Treasury Inspector General For Tax Administration, "Trends in Compliance Activities Through Fiscal Year 2006," U.S. Treasury Department, <http://www.treas.gov/tigta/auditreports/2007reports/200730056fr.html> (accessed October 16th, 2007).

<sup>43</sup> Internal Revenue Service, "SOI Tax Stats—IRS Data Books."

<sup>44</sup> Ibid.

<sup>45</sup> Transactional Records Access Clearinghouse, "Targeting of Correspondence Audit Improves," Syracuse University, <http://trac.syr.edu/tracirs/newfindings/current> (accessed October 17, 2007).

## EXPAND INTERNAL TAX COLLECTION

Tax law enforcement does not end once an audit has been completed. The IRS will have to actively pursue unpaid taxes it identifies if they are not paid voluntarily. IRS collection officers may make an agreement with the taxpayer to pay the taxes, or issue levies, liens, or property seizures. Agents are also charged with identifying taxpayers who do not file a tax return and collecting the taxes owed. To do these things, significant staffing and resources are required.

Billions are lost annually because Congress does not sufficiently finance the IRS collection department. In 2002, former IRS Commissioner Charles Rossotti reported to the IRS Oversight Board that an annual investment of under \$400 million in IRS collections could generate over \$11 billion each year.<sup>46</sup> This additional funding could be used to hire more full-time employees to pursue cases the IRS has not taken action on due to insufficient personnel. Even without additional resources, NTA Nina Olson has recently stated the IRS can tackle many of those additional cases by implementing improvements to its current collection regimes.

Since Rossotti issued the 2002 report, activity in the collection function has increased modestly. Some key measurements have been on a steady upward trajectory, including the quantity of liens and levies issued by IRS collection staff.<sup>47</sup> However, the level of liens and levies is still down sharply from fiscal year 1996 levels, even excluding growth in the economy and tax returns. Some measures—such as the quantity of seizures—have not increased at all. Indeed, a 2007 Treasury Inspector General for Tax Administration (TIGTA) report found a robust collection function continues to be hampered by inadequate resources, as staffing for collection activities remains 30 percent below fiscal year 1997 levels.<sup>48</sup>

*Wrong Strategy: Private Debt Collection*

In 2004, Congress enacted—and in September 2006, the IRS implemented—a program to outsource the responsibility of collecting small tax debts to private debt collection firms. The principle rationale for creating the program was that its funding would not show up in the IRS budget. Although the Government still spends resources, using private collectors does not require additional annual appropriations. Under the program, private collectors get to keep a portion of the taxes they collect as payment. Therefore, given limited budgets, the IRS would be afforded an opportunity to collect taxes it otherwise could not.

However, the private tax collection program is wasteful and dangerous. Private collection agencies (PCAs) yield a return-on-investment (ROI) of 4:1, whereas—as former IRS Commissioner Mark Everson has acknowledged—Federal employees at the IRS produce a 13:1 ROI. Even more efficient, the IRS' Automated Collection System currently collects about \$20 for every \$1 spent on staffing, according to the NTA.<sup>49</sup>

Furthermore, despite claims the program has no costs, as of May 23, 2007, the IRS had spent \$71 million in appropriated funding to set it up. If that money had instead been spent on those high-yield automated functions, an additional \$1.4 billion in revenues could have been collected in just 1 year. Yet for all those missed opportunities, the private collection program is expected to yield only around \$1.1 billion altogether over the next 10 years.

Initial data on the program are now available for the first year of operation, and the Washington Post has reported the PCAs averaged a 4.5:1 ROI, collecting \$29 million, from which they were paid \$6.34 million—far below both the IRS' ROI levels and initial revenue projections for the program.<sup>50</sup>

Regardless of the program's cost, many experts continue to worry PCAs might violate taxpayer rights. Olson has expressed a great deal of concern that profit-motivated companies could abuse taxpayers. According to Olson, PCAs have the opportunity to use “trickery, device, and belated Fair Debt Collection Practices Act warn-

<sup>46</sup> Charles O. Rossotti, “Report to the IRS Oversight Board: Assessment of the IRS and Tax System.”

<sup>47</sup> Transactional Records Access Clearinghouse, “IRS Collection Enforcement Trends,” Syracuse University, <http://trac.syr.edu/tracirs/highlights/current/collenfG.html> (accessed October 16, 2007).

<sup>48</sup> Treasury Inspector General for Tax Administration, “Trends In Compliance Activities Through Fiscal Year 2006.”

<sup>49</sup> National Taxpayer Advocate Service, “National Taxpayer Advocate's 2007 Annual Report to Congress,” Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=177301,00.html> (accessed January 9, 2008).

<sup>50</sup> Business Section “Collectors Get \$29 Million for IRS,” Washington Post, January 9, 2008, <http://www.washingtonpost.com/wp-dyn/content/article/2008/01/08/AR2008010804439.html>.

ings to take advantage of taxpayers,” and yet they are not obligated to disclose their “operational plans” regarding practices, letters, or scripts they will use.<sup>51</sup>

Indeed, anecdotal reports on the program’s operations have borne out many of the concerns Olson voiced regarding abusive practices. At a May 23, 2007, hearing of the House Ways and Means Committee, Rep. John Lewis (D-GA) presented tapes of conversations between PCA employees and taxpayers.<sup>52</sup> Due to IRS privacy protections, PCA employees did not identify themselves, the nature of their business, or the purpose of their calls, and haggled with taxpayers to obtain their Social Security numbers. The taxpayers in the conversations refused to reveal their Social Security numbers and responded angrily when PCA employees asked repeatedly for the numbers but did not disclose the purpose of the conversations.

Olson reiterated her concerns about the ability of the program to operate efficiently and effectively in the recently released 2007 NTA report, stating tax collection is an inherently governmental function that should be handled only by Government employees trained to protect taxpayer rights. Olson argues the IRS could currently collect the outstanding debts given to the PCAs by improving its collection strategy and use of currently available resources, enabling the IRS to reach “most, if not all, of these cases [given to PCAs] at less cost to taxpayers and less risk to taxpayer rights.”<sup>53</sup>

The sum of the evidence supports the need to shut down this program immediately. In 2007, Ways and Means Chairman Charles Rangel (D-NY) requested the IRS not issue any new contracts for the program, and the House passed a bill in October 2007 to end it entirely. This would be a wise change in IRS policy. Unfortunately, the IRS is moving forward with soliciting bids from additional PCAs for the second part of the program—full implementation. While Olson has pushed the IRS to include more transparency and taxpayer safeguards in the solicitation of new contracts, she continues to voice strong concerns and recommends Congress end the program.

Congress needs to act immediately to end this program and instead should make more resources available to the IRS to expand existing internal collection efforts.

#### INCREASE SERVICES FOR EITC TAXPAYERS

Re-establishing a robust auditing regime at the IRS is crucial to closing the tax gap. But focusing on enforcement at every turn, particularly having that focus land disproportionately on low-income taxpayers, is not the best solution. The IRS has taken an approach to overseeing and enforcing the Earned Income Tax Credit (EITC) that relies far too much on audits and not enough on services. This is unfair to those taxpayers who claim the EITC, who are held to a higher standard by the IRS than any other taxpayer group, and it fails to address EITC over-claims caused by errors, not malfeasance.

The EITC is a refundable tax credit for low-income workers. In tax year 2005, the EITC provided more than \$41 billion to over 21 million families and individuals.<sup>54</sup> It lifts more working families out of poverty than any other work support; in 2003, the EITC helped raise 4.4 million people, including 2.4 million children, above the poverty line.<sup>55</sup>

Since it is a tax credit, the IRS administers the EITC and is responsible for maintaining its integrity. In 1999, the IRS estimated the EITC noncompliance rate at between 27 and 32 percent, resulting in between \$8.5 to \$9.9 billion annually in overpayments, or about 3 percent of the tax gap (though the NTA believes that rate is overstated).<sup>56</sup>

<sup>51</sup>National Taxpayer Advocate Service, “National Taxpayer Advocate’s 2006 Annual Report to Congress,” Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=165806,00.html> (accessed October 16, 2007).

<sup>52</sup>For a transcript of the tapes, see <http://waysandmeans.house.gov/media/pdf/110/07%2005%2023%20Debt%20Collector%20call%20transcript.pdf>.

<sup>53</sup>National Taxpayer Advocate Service, “National Taxpayer Advocate’s 2007 Annual Report to Congress,” Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=177301,00.html> (accessed January 9, 2008).

<sup>54</sup>Center on Budget and Policy Priorities, “EIC Participation for Tax Year 2005, by State,” <http://www.cbpp.org/eic2008/docs/EIC%20participation%20prelim%20ty%202005.pdf> (accessed October 17, 2007).

<sup>55</sup>Robert Greenstein, “The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor,” Center on Budget and Policy Priorities, <http://www.cbpp.org/7-19-05eic.htm> (accessed October 17, 2007).

<sup>56</sup>Ibid.

*Wrong Strategy: Punishing EITC Taxpayers*

Mostly by congressional mandate, the IRS has taken a punitive approach to EITC error reduction. Congress designates a portion of the annual IRS budget specifically for EITC compliance. In fiscal year 2006, Congress allocated \$167 million for EITC compliance, which the IRS used on several initiatives that focus disproportionate enforcement efforts on EITC taxpayers.

With this funding, Congress has instructed the IRS to heavily audit EITC taxpayers. Under the EITC compliance initiative in fiscal year 2006, almost 517,617 audits were performed on tax returns where the EITC was claimed. These audits constituted about 40 percent of all audits performed on individual tax returns in fiscal year 2006.<sup>57</sup> The examination rate for EITC recipients was 2.25 percent, compared to 1 percent for all individual income tax returns, and 1.3 percent of all individuals making over \$100,000.<sup>58</sup> Yet EITC audits yield only a fraction of the total revenues recovered by IRS examinations. EITC audits identified nearly \$1.5 billion in excess payments, resulting in a yield of only \$2,895 per audit—the lowest rate of return for any type of audit performed by the IRS.<sup>59</sup>

Aside from a disproportionately large number of audits, EITC taxpayers are subject to a set of additional enforcement programs. First, the IRS applies a unique type of examination—called “recertification”—only to EITC taxpayers. The recertification program requires taxpayers to “recertify” if they had the EITC denied during an examination. This denial places recertification indicators on a taxpayer’s account until the taxpayer proves he or she is eligible to receive the credit again. Once the taxpayer has provided sufficient evidence, he or she is deemed “recertified,” and the taxpayer is once again eligible for the EITC. The number of taxpayers subject to this recertification tripled from 326,000 in September 1999 to almost 1 million by December 2003.<sup>60</sup> No other tax credit, deduction, or exemption requires such a high burden of proof.

The IRS has also put holds on millions of refunds to crack down on EITC errors. Beginning in 2005, the Criminal Investigations Division of the IRS began a program that postponed sending EITC refunds to people suspected of fraud. The NTA’s 2005 Report to Congress revealed that of the 1.6 million taxpayers who had their refunds frozen, 75 percent were EITC recipients.<sup>61</sup> In 80 percent of the frozen refund cases brought to the NTA last year, the IRS ended up paying full or partial refunds, indicating a very large percentage of innocent filers had to face hardships resulting from delayed refunds.

Moreover, anecdotal evidence indicates the fear of punitive action by the IRS discourages workers from claiming the EITC. Currently, one in five workers who is eligible for the EITC does not claim it. Much of the energy and funding the IRS devotes to EITC compliance programs could be better spent by offering the helping hand of taxpayer services rather than punitive enforcement.

*Expanded Assistance Would Reduce Error Rates*

The EITC error rate could be significantly reduced by increasing the capacity of nonprofit or Government tax preparation services to assist EITC-eligible taxpayers.<sup>62</sup> EITC error rates do not distinguish taxpayers who intentionally cheated on their returns from those who simply made mistakes. EITC filings are complicated, requiring a 50-page instruction manual,<sup>63</sup> and therefore, many EITC overclaims are the result of mistakes that could be prevented. In fact, as much as 50 percent of all tax returns with errors are thought to be unintentional and have been linked to the complexity of EITC eligibility requirements.<sup>64</sup> These errors could be addressed principally by simplifying tax laws and, when necessary, giving taxpayers help in preparing what may unavoidably be a complicated application process.

Through its nationwide network of Taxpayer Assistance Centers (TACs), the IRS makes tax return preparation services available for low-income tax filers on a walk-

<sup>57</sup> Internal Revenue Service, “SOI Tax Stats—IRS Data Books.”

<sup>58</sup> *Ibid.*

<sup>59</sup> *Ibid.*

<sup>60</sup> Treasury Inspector General for Tax Administration, “The Earned Income Credit Recertification Program Continues to Experience Problems,” U.S. Department of Treasury, <http://www.treas.gov/tigta/auditreports/2005reports/200540039fr.html> (accessed October 17, 2007).

<sup>61</sup> National Taxpayer Advocate Service, “National Taxpayer Advocate’s 2005 Annual Report to Congress,” Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=152735,00.html> (accessed October 17, 2007).

<sup>62</sup> Another effective approach is to simplify the credit. See Max Sawicky, “Where the Money Isn’t,” Economic Policy Institute, [http://www.epinet.org/content.cfm/issuebriefs\\_ib183](http://www.epinet.org/content.cfm/issuebriefs_ib183).

<sup>63</sup> See the IRS web site for the manual: <http://www.irs.gov/pub/irs-pdf/p596.pdf>.

<sup>64</sup> Max Sawicky, “Where the Money Isn’t,” Economic Policy Institute, [http://www.epinet.org/content.cfm/issuebriefs\\_ib183](http://www.epinet.org/content.cfm/issuebriefs_ib183) (accessed October 17, 2007).



in basis. Studies have found IRS-prepared returns from these centers are substantially more accurate than both self-prepared and commercially prepared returns.<sup>65</sup> Audits show that TAC-prepared EITC returns resulted in between \$640–\$1,300 less in erroneous payments than unprepared returns.<sup>66</sup>

Yet the IRS has decided to reduce the quantity and quality of services available at TACs. The number of tax returns TACs prepared declined from 665,868 in fiscal year 2003 to a projected 406,612 in fiscal year 2006.<sup>67</sup> A 2006 report by TIGTA also found more than 10 percent of TACs (47 of 400) were critically understaffed.<sup>68</sup> As the sheer volume of returns processed by TACs has decreased, the range of services they provide has also been narrowed.<sup>69</sup> For example, in North Dakota, where farming is a major industry, the TACs have been instructed not to answer questions related to reporting farm income on tax returns.<sup>70</sup> As more evidence of the detrimental combination of limited resources and unwise decisions at the IRS, employees at TACs have also been reassigned to jobs unrelated to taxpayer assistance, including being instructed to perform collection activities. This change diverts additional resources away from services offered at TACs.<sup>71</sup>

Even more worrisome, the IRS has also been attempting to close TACs. In 2005, the IRS announced plans to shut down 68 of the 400 TACs nationwide. Before the IRS could carry out these plans, Congress passed a bill prohibiting the IRS from closing the TACs until TIGTA could evaluate the potential impact the closures would have on taxpayers. In March 2006, TIGTA completed the report, which concluded the data concerning TAC usage, on which the IRS based its plans for TAC closures, was unreliable. IRS has so far delayed the closures.<sup>72</sup>

Dedicating additional resources to low-income services would have the benefit of reducing EITC error rates, closing the tax gap, and expanding needed services to more low-income taxpayers. At a minimum, the IRS and Congress should dedicate sufficient resources to maintain existing TACs. Even more funding would make the TAC network more responsive to taxpayer needs, both by opening more centers around the country and expanding the scope of services offered to taxpayers.

#### TAX ENFORCEMENT HAS TO BE A PRIORITY

The tax gap is an eminently solvable problem. If Congress were to prioritize funding for IRS examination, collection, and tax preparation services, it would drastically reduce the tax gap. The practical effect of expanding these activities at the IRS would be to make the tax code more equitable, and it would bring in additional revenue that could responsibly finance new programs and services. If implemented in the right way, closing the tax gap could also help to increase public confidence in the tax system and the Federal Government.

Congress needs to enact sustained increases in the IRS budget immediately and should make a commitment to continue to provide the IRS with the extra resources that are so crucial to effective tax enforcement.

This report has only highlighted a few sections of the IRS budget that merit additional funding and reforms. However, it refrains from specifying the dollar amounts needed to address these concerns and recommends a thorough congressional review of the entire IRS budget. We believe Congress, IRS administrators, and outside experts, upon whose research and expertise this report mainly relies, should come together to find common ground on what an appropriate funding increase would look like, how quickly it should be implemented, and how it could be sustained in coming years. Most experts, both inside the IRS and out, prefer gradual increases in fund-

<sup>65</sup>Nina Olson, "The IRS and the Tax Gap," Testimony before the Committee on the Budget, U.S. House of Representatives, [http://www.house.gov/budget\\_democrats/hearings/2007/08OlsonTestimony.pdf](http://www.house.gov/budget_democrats/hearings/2007/08OlsonTestimony.pdf) (accessed October 16, 2007).

<sup>66</sup>Ibid.

<sup>67</sup>Nina Olson, "Hearing on Internal Revenue Service Fiscal Year 2008 Budget Request" Written Statement before the Subcommittee on Financial Services and General Government Committee on Appropriations, U.S. Senate, April 9, 2007.

<sup>68</sup>Treasury Inspector General for Tax Administration, "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season But Challenges Remain for the Taxpayer Assistance Program." U.S. Department of Treasury, <http://www.treas.gov/tigta/auditreports/2006reports/200640067fr.pdf> (accessed October 16, 2007).

<sup>69</sup>National Taxpayer Advocate Service, "National Taxpayer Advocate's 2005 Annual Report to Congress," Internal Revenue Service. <http://www.irs.gov/advocate/article/0,,id=152735,00.html>

<sup>70</sup>Nina Olson, "Hearing on Internal Revenue Service Fiscal Year 2008 Budget Request."

<sup>71</sup>National Taxpayer Advocate Service, "National Taxpayer Advocate's 2005 Annual Report to Congress," Internal Revenue Service. <http://www.irs.gov/advocate/article/0,,id=152735,00.html>

<sup>72</sup>Treasury Inspector General for Tax Administration, "The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data." U.S. Department of Treasury, <http://www.treas.gov/tigta/auditreports/2006reports/200640061fr.pdf> (accessed October 16, 2006).

ing, as opposed to a sudden increase. A sudden increase would likely overwhelm the IRS and be implemented inefficiently and with too little oversight. Despite this recommendation, we believe the IRS funding shortage is an urgent matter and should be addressed as quickly as possible.

Ultimately, as with most fiscal issues, the root of the problem is political. The case must be made that fears of an IRS run amok are, in a way, a self-fulfilling prophecy. Attempting to curtail the powers of the IRS through inadequate funding levels has had unintended consequences—it has forced the IRS to institute policies and enforcement practices detrimental to tax collection, taxpayers' rights, and the progressivity of the tax code. So long as the IRS is underfunded, it will be forced to enforce the tax code unfairly and punitively. However, if the IRS is properly funded and administered correctly, the Federal Government will have the opportunity to make substantial progress in reducing the tax gap and to ensure the tax system is as progressive in practice as it is in law.

#### STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. The IRS administers the tax laws and collects \$2.4 trillion in revenue that fund over 96 percent of Federal Government operations. With approximately 90,000 employees, the IRS is effectively the accounts receivable department of the United States. Simply stated, the more revenue the IRS collects, the more revenue Congress may spend to either cut taxes, reduce the deficit, or advance important programs. And conversely, the less that is collected, the less revenue Congress has for these same purposes.

The IRS relies on three sources of funds it needs to operate: appropriated funds, user fees, and reimbursables, which are payments to the IRS which they receive from other Federal agencies and State government for services. Nearly the entire IRS budget, 97 percent of it, is derived from appropriated funds.

For fiscal year 2009, the Bush administration is asking a direct appropriation of \$11.36 billion. It is an overall increase of \$469 million, or 4.3 percent, above fiscal year 2008.

In addition to the request for appropriated funds in fiscal year 2009, the IRS also expects to realize nearly \$108 million from reimbursable programs and \$177 million in user fees, bringing total spending to \$11.647 billion.

By breakdown of the nearly \$11.4 billion appropriation requested, \$2.15 billion is for taxpayer services; \$5.12 billion for enforcement; \$3.86 billion for operations support; \$222.7 million for business system modernization; and \$15.4 million for health insurance tax credit administration.

As the subcommittee evaluates the President's request, we will take stock of the recommendations of the Oversight Board and a lot of experts. I know the Oversight Board is tasked by law to review and assess the annual budget request for the IRS to make sure it supports the agency's annual and long-term strategic plans.

Before we hear our panelists, I would like to mention just a few of the issues we will be considering.

First, how does the proposed budget address the tax gap? The great majority of Americans pay their fair share of taxes, but there is still a significant tax gap. That is the difference between what taxpayers are supposed to pay and what they actually pay. I note that as part of its budget submission, the IRS proposes 16 legislative reforms to recoup \$36 billion of the \$290 billion net tax gap over the next 10 years.

Questions have been raised that such an approach is not aggressive enough and amounts to a return of just slightly over a penny

on the dollar. I am anxious to hear perspectives from our panel members.

Second, does this proposed budget achieve the proper balance between enforcement and service? It is fundamental that as enforcement initiatives to boost compliance are advanced, resources for taxpayer services not be sacrificed. Taxpayer service plays an integral role in facilitating voluntary compliance.

Third, does the proposed budget promote critical investments and ensure meaningful progress in information technology enhancements? Let me just say that we know that the IRS is facing, in addition to the regular tax return filing season, the issuance of \$100 billion in stimulus payments in the form of rebate checks over the next few months. I understand that as of March 28, the IRS received an estimated 1.4 million tax returns from individuals who filed them solely to receive the rebates. I also understand the IRS has been receiving an average of more than 63,000 calls per day above the normal volume asking questions about the rebates.

Let me just say there are many topics of concern that we will go into in the hearing, but in the interest of moving it along, I am going to ask my colleague, Senator Allard from Colorado, if he has an opening statement or a comment that he would like to make.

Senator ALLARD. I do, Mr. Chairman, just brief comment, if I might.

Senator DURBIN. And when he is finished, we will proceed with questions.

#### STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman, for holding today's hearing. I would like to thank our panelists for joining us this afternoon.

For some time now, I have been following closely and showing some concern on the IRS's ongoing audit process involving the conservation easement donations in Colorado. I understand Colorado is one of the top States in the number of conservation efforts that it has undertaken, and it is an issue of great importance to our State and many people in it and our quality of life as far as our goals for open space. And I support the IRS investigation and enforcement of legitimate fraud in an effort to route out abuse of the conservation easements tax credit program.

However, at times I wonder if the IRS has wrongly targeted honest and hardworking Coloradans throughout their investigation. I hope that they would refocus its investigation and approach the issue in a fair and reasonable manner. There are at least 96 audits involving donations to mainstream conservation organizations that follow the letter and the spirit of the law, I believe. Some of the 96 donations were verified by legitimate conservation easements by the U.S. Department of Agriculture and other Government agencies, I am led to believe.

I would urge you to follow the model set by Colorado and refocus on cases involving an appraiser or land trust who has been disciplined or is currently under investigation by the State. Hopefully, this approach will rightly target the actual abuse, while releasing lawful easement donations from multiyear, stressful, and unjustified audits.

So we will be following this particular area closely, Mr. Chairman. My office has been contacted by a number of organizations that work with these easements. And I would encourage the Internal Revenue Service on their investigations to use common sense in their approach, and I understand that there are violations and there have been reasons why you have had to look at some of these deals in Colorado. But on the other hand, we hope that we do not get too broad and snare and tie up innocent parties that perhaps did not violate the law.

So thank you very much, Mr. Chairman.

Senator DURBIN. Thank you, Senator Allard.

[The statement follows:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

Thank you, Mr. Chairman, for holding today's hearing. I would also like to thank our panelists for joining us this afternoon.

For some time now I have been involved and concerned by the IRS' ongoing audit process involving conservation easement donations in Colorado. Colorado is a national leader in conservation, and it is an issue of great importance to our state's economy and quality of life.

I support the IRS' investigation and enforcement of legitimate fraud in an effort to root out abuse of the conservation easement tax credit program. However, I feel the IRS has wrongly targeted honest and hard working Coloradoans throughout their investigation.

I hope the IRS would refocus its investigation and approach the issue in a fair and reasonable manner. There are at least 96 audits involving donations to mainstream conservation organizations that follow the letter and spirit of the law. Some of these 96 donations were verified to be legitimate conservation easements by the U.S. Department of Agriculture and other Government agencies.

The IRS should follow the model set by Colorado and refocus on cases involving an appraiser or land trust who has been disciplined or is currently under investigation by the State. This approach will rightly target the actual abuse while releasing lawful easement donors from multi-year, stressful, and unjustified audits.

If the IRS decides not to alter the ongoing audit process they and the hard-working taxpayers can expect a long drawn-out battle. If they stay on their current course, the IRS may be faced with over 200 appeals. This many appeals will take a lot of time and resources to build a case for every easement in question. At what cost? The American taxpayers are on the hook for this process that has been going on for several years already and there is no end in sight.

There is a significant need for conservation easements in Colorado and a few abuses should not end the charitable tax credit for everyone.

Thank you, Mr. Chairman.

Senator DURBIN. Senator Brownback.

STATEMENT OF SENATOR SAM BROWNBACK

Senator BROWNBACK. Thank you very much, Mr. Chairman. I appreciate this.

Welcome, Commissioner. Glad to have you here, 4 weeks onto the job. Yesterday, I guess, was your big day. The rest of us were not celebrating yesterday. But delighted to have you here and in that job and position.

I do want to make a point about yesterday, and I appreciate the hearing, appreciate you being here on our budget. But I was noting in my opening remarks that on the complexity of the Tax Code, you have 800 different IRS tax forms—800. And I do not know if any one person fills out all 800 of them. If they fill out 100 of them or if they fill out 50, this is an unbelievably complex Tax Code. That is your problem to enforce, but that is our problem in the creation

of it. And as I just pointed out I think we are well overdue for tax simplification.

You are only 4 weeks into a job, but it is a 5-year appointment, and I would hope that over the period of time that you are Commissioner, that you really help us work on tax simplification and that you become an advocate for it. I mention that you note there is a part of your enforcement problem that is involved the so-called tax gap. In your congressional budget justification, you state that a major contributing factor to the tax gap is that our tax system is so complex that taxpayers cannot figure out what they owe. So a big part of your enforcement problem is taxpayers not being able to figure out which of the 800 forms they are supposed to fill out. That is why I really think we have got to look at tax simplification.

I have put forward a proposal, an optional flat tax, leave the Code in place, but let people choose a simpler system. And I do not expect you to put a proposal forward in the short term while you are in, but I do hope during the time that you are Commissioner you really help us wrestle with that problem. It will make your job a lot simpler. I think it will be well received across the country, that they want to see a simpler, fairer, flatter system, and I would hope that we could learn in your position to get a Code that is a lot easier for people to understand and a lot easier to enforce too.

Thank you, Mr. Chairman.

[The statement follows:]

#### PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Good afternoon. I want to thank you, Chairman Durbin, for your leadership on this subcommittee. As always, I look forward to working with you during this coming year as we make funding decisions and provide oversight to the various agencies within this subcommittee's jurisdiction.

Commissioner Shulman, thank you for appearing before our subcommittee today. I understand you have only been with the IRS a few weeks, so this is certainly a busy time for you to be taking the reins. I'm pleased we have such a highly qualified person in the job and I look forward to hearing the details of your fiscal year 2009 budget request. Your budget justification says that the IRS "represents the face of the U.S. government to more American citizens than any other agency." As surprising as it may seem in Washington, many Americans only come into direct contact with the Federal Government on Tax Day. I appreciate the work that you and your staff do to ensure taxpayer compliance and to provide taxpayer assistance.

I must take this opportunity, though, to express my deep concerns about the current tax system. Yesterday was a dark day for most Americans as they rushed to file their tax returns. Every year, taxpayers suffer under the burden of our complex and complicated tax code, confused by over 800 different IRS tax forms, perplexed by hundreds of pages of IRS instruction books, and nervous that they will make a mistake trying to calculate how much of their money they owe the Federal Government.

This current maze of tax regulations is so convoluted and complex that many Americans believe it is not only incomprehensible, but unfair. This confusion is one reason why almost two-thirds of all taxpayers have given up on trying to figure out how to complete their own tax returns and now spend even more of their hard-earned wages to pay someone else to sort it all out.

I'm not blaming you for this state of affairs, Commissioner Shulman. Lawmakers have created this labyrinthine maze and you and your people are just working to administer it.

Looking at the President's budget request, I am pleased that it includes a 7 percent increase for taxpayer enforcement to work toward closing the so-called "tax gap." Certainly, we must ensure that taxes which are owed are collected. But your own congressional budget justification states that a major contributing factor to the "tax gap" is that our tax system is so complex that taxpayers cannot figure out what they owe. I have been informed that the annual tax gap is about \$290 billion. I'm glad to see that the IRS is devoting resources to closing this gap, but I believe that

as long as we have this convoluted and burdensome system, the gap between taxes owed and taxes paid will remain substantial.

Again, Commissioner Shulman, this system is one that you have inherited. I am in no way blaming you for this state of affairs. But I have to take this opportunity to continue to push for an optional flat Federal income tax. A flat tax would be a clear and fair way for American families to figure out what they owe and put it on a one-page form to the Federal Government. As long as a flat tax rate is reasonable, it is a fairer tax than the current system because it taxes all earned income at the same rate. Workers would not be punished for working harder and earning more money, because each dollar that they earn would be taxed at the same exact rate. This would be fairer, simpler, easier to understand, and would produce more economic activity and jobs.

Finally, I am pleased that Americans will soon be receiving economic stimulus checks in the mail. I certainly support these tax rebates to hard-working families. But the complexity of the tax system was again evident when the IRS recently had to hold a "Super Saturday," opening hundreds of IRS offices to help folks file their returns so that they could receive their economic stimulus payments. In fact, your agency must spend over \$2 billion every year just to help people figure out how to complete their tax returns. Quite frankly, that says it all.

So Commissioner Shulman, I thank you for your service and I look forward to hearing your testimony this afternoon.

Thank you, Mr. Chairman.

#### STATEMENT OF IRS COMMISSIONER DOUGLAS SHULMAN

Senator DURBIN. Thanks a lot.

Commissioner Shulman, the table is yours for a 5-minute statement. All the rest will be put in the record. And welcome.

Mr. SHULMAN. Thank you, Chairman Durbin, Ranking Member Brownback, Senator Allard. I appreciate the opportunity to appear here before the subcommittee. As you have noted and noticed, I am in my fourth week on the job. Let me reiterate to this subcommittee that I look forward to working with you during my entire tenure here to address the critical issues related to the IRS.

I would also like to introduce the IRS's two Deputy Commissioners, Richard Spires and Linda Stiff, who are here with me today. They have really done an excellent job guiding the agency through what, by any measure, are some tough times: this filing season, the late enactment of the alternative minimum tax (AMT) legislation, and then the stimulus package. I am lucky to have them on the team. I also wanted to make sure we are responsive to any questions and given that I am 4 weeks into this, I wanted to make sure they were here with me today.

This morning I will touch quickly on the filing season and our proposed budget, but I will also try to give you a little sense of my approach to the job.

Yesterday we completed what looks like a successful filing season. Electronic filers were up 10 percent as of yesterday. The number of returns prepared by our volunteer income tax assistance and tax counseling for the elderly centers throughout the country were up 26 percent. The usage of our Free File program, which allows 70 percent of all Americans to prepare and file their returns electronically, was up 20 percent this year. And visits to IRS.gov were up 21 percent.

We also, as I mentioned, are having a successful filing season despite some pressures, including late enactment of the AMT and, as you mentioned, Mr. Chairman, the stimulus program which was put on top of filing season.

Regarding the stimulus program, we have done an extensive outreach program to make sure Americans know that all they need to do is file a tax return in order to get a stimulus payment. We put particular emphasis on informing Americans who normally would not file a return, but are eligible for stimulus payments, that they need to file a return this year. These are people who receive Social Security, receive veterans benefits, low income workers.

I also want to urge this subcommittee to support full funding of the IRS's 2009 budget request. This budget will allow us to continue a strong emphasis on taxpayer service, but also to continue to build on our good record of enforcement programs to target non-compliance.

During my confirmation process, I was asked by the Senate Finance Committee whether I thought it was most important to focus on service or to focus on enforcement. And my answer there—and I fervently believe this—is that for the IRS to achieve its compliance objectives, we have to continue to focus on both service and enforcement. Said another way, I think we need to do everything we can to make it as seamless and easy as possible for taxpayers who want to pay the right amount of taxes to navigate our organization, get their questions answered, pay their taxes, and get on their way. But for anyone who understands his or her tax obligation and is trying to evade that obligation, we need to have aggressive enforcement programs.

Another area of focus for me will be technology modernization. The evolution of technology has changed the way that every major organization, private and public, goes about doing its work. As we adapt to this changing world, my goal is relatively simple. It is to get the right information into the hands of the right people at the right time, whether that is getting information into the hands of taxpayers or our people trying to do service or enforcement.

The other area I would mention quickly is our need to continue to focus on leadership and workforce. The IRS, like other Government agencies, is going to have a lot of people retiring in the next couple of years. There is competition for talent, and we are going to need to keep focusing on building our next generation of leaders and developing our workforce.

#### PREPARED STATEMENT

So let me thank you again, Mr. Chairman, for the opportunity to appear this morning. In my short tenure, I have found the people at the IRS to be extremely professional, hardworking, and dedicated to the American people every day. I am committed to work every day to provide the level of service that taxpayers deserve, as well as to rigorously enforce the tax laws. We obviously need resources to execute this mission, and I encourage this subcommittee to fully fund the administration's 2009 proposed budget. Thank you, and I am happy to answer questions.

Senator DURBIN. Thanks, Mr. Commissioner.

[The statement follows:]

## PREPARED STATEMENT OF DOUGLAS SHULMAN

## INTRODUCTION

Chairman Durbin, Ranking Member Brownback, and members of the subcommittee, thank you for the opportunity to appear today. This is my third hearing as the IRS Commissioner and I look forward to working with the Members of this subcommittee in the future as we address issues related to the IRS.

As I settle in to my new role, it becomes clearer to me each day what a privilege it is to be the Commissioner of the IRS. The IRS and its employees represent the face of United States Government to more American citizens than any other Government agency. We administer America's tax laws and collect over 96 percent of the revenues that fund the Federal Government each year.

My most recent experience has been as the Vice Chairman of the Financial Industry Regulatory Authority (FINRA), formerly the NASD. In 2007, NASD consolidated with the member regulation, enforcement, and arbitration functions of the New York Stock Exchange to form FINRA. Based on my previous experience, I believe that leaders of large organizations—public and private—always must be focused on ensuring that resources are aligned with strategic priorities. It is incredibly important that there be a balance of resources between day-to-day execution and investments for the longer term. In my first 4 weeks, I have been working with the senior executive team of the IRS to understand how resource allocation decisions have been made. The subcommittee can expect ongoing dialog and personal engagement from me on these issues.

## 2008 FILING SEASON

The biggest challenge the IRS faced at the end of 2007, as it approached the 2008 filing season, was the uncertain status of legislation to address the situation of an additional 21 million taxpayers who otherwise would have become subject to the alternative minimum tax (AMT).

On October 30, 2007, Chairman Baucus, Ranking Member Grassley of the Senate Finance Committee House and their counterparts on the House Ways and Means Committee, sent a letter assuring the IRS that Congress intended to enact AMT relief (the AMT patch) in a manner acceptable to the Senate, the House of Representatives, and the President. I am told that this letter was very helpful because it allowed the IRS to move forward on certain planning and design aspects of implementing the AMT relief legislation, shortening the implementation process by a number of weeks.

However, the IRS indicated at the time that its key systems could accommodate only one programming option without introducing excessive risk to the filing season. As a result, the IRS was able to proceed only so far without actual legislation being enacted. When the President signed the AMT relief law on December 26, 2007, the IRS immediately began the detailed reprogramming of systems to accommodate the new law. IRS employees worked diligently to modify systems to implement the changes in a very short time period. My thanks go out to all of those dedicated employees who worked almost around the clock to enable us to implement this AMT relief legislation in record time.

Given their efforts, we were able to begin the filing season on schedule for most taxpayers. However, the processing of returns filed by approximately 13.5 million taxpayers that included one of five forms associated with the AMT legislation was delayed. These taxpayers had to wait until February 11, 2008, before their returns could be processed.

The other challenge facing us this filing season is the implementation of the economic stimulus package enacted in early February, specifically the planning for the distribution of the stimulus payments to eligible recipients throughout the country this spring. To deliver the 2008 stimulus payments, we have been programming our systems to calculate the appropriate amount for each eligible taxpayer based on their 2007 returns so that the payments can be distributed, through Treasury's Financial Management Service, by direct deposit or by paper check, based on the preferences expressed on the taxpayer's return.

We will begin immediately after the close of the filing season to distribute those payments with the expectation that the first payments will be sent electronically starting in the first week of May and with the first paper checks being mailed shortly thereafter. We have established a distribution schedule that is published on the IRS website on a page dedicated to informing citizens about the economic stimulus payments.

However, there are millions of individuals who may be eligible for economic stimulus payments, but who typically do not have an income tax filing requirement. This



group includes retirees or those who have minimal income and are thus not required to file. But in order to receive the 2008 stimulus payment, the recipient must file a tax return for 2007. To reach these recipients and educate them requires an extensive outreach program that includes the mailing of information packets and IRS coordinating with the Social Security Administration and Department of Veterans Affairs, along with private groups such as the AARP.

Despite the challenges presented by the late enactment of the AMT patch and the implementation of the economic stimulus payments, I am proud to report that thus far the filing season has gone very well. Allow me first to give an update on some of the numbers we are looking at as we close out the filing season.

#### *Numbers Thus Far*

We expect to process nearly 140 million individual tax returns in 2008, and we anticipate continued growth in the number of those that are e-filed. In the 2007 filing season, almost 60 percent of all income tax returns were e-filed. We fully expect to exceed that number this year. As of April 5, we have received over 67 million tax returns electronically, an increase of 10 percent compared to the number of returns that were e-filed during the same period last year.

This increase in e-filing is being driven by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by 18.2 percent compared to the number of self-prepared returns filed during the same period a year ago. Over 19 million returns have been e-filed by people from their personal computers, up from just over 17 million for the same period a year ago.

Overall, nearly 70 percent of the returns filed through April 5 have been e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in 2 weeks or less. That is about half the time it takes us to process a paper return. For the IRS, the error-reject rate for e-filed returns is significantly lower than that for paper returns.

More people are choosing to have their tax refunds deposited directly into their bank account than ever before. As of April 5, we have directly deposited over 53.6 million refunds, or over 71 percent of all refunds issued this tax filing season.

People are also visiting our web site—IRS.gov—in record numbers. We have recorded over 132 million visits to our site this year, up over 21 percent from 109 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the IRS.gov web site. The web site:

- Allows taxpayers to obtain information on the economic stimulus package including determining the payment amount they can expect to receive and learning when they can expect their payment based on their Social Security Number (SSN);
- Assists taxpayers in determining whether they qualify for the Earned Income Tax Credit (EITC);
- Assists taxpayers in determining whether they are subject to the Alternative Minimum Tax (AMT);
- Allows more than 70 percent of taxpayers the option to prepare and file their tax returns at no cost through the Free File program. This includes giving a free option for those taxpayers who normally do not file a tax return, but are required to this year in order to receive their stimulus payment;
- Allows taxpayers who are expecting refunds to track the status via the “Where’s My Refund?” feature; and
- Allows taxpayers to calculate the amount of their deduction for State and local sales taxes.

We have issued 75.1 million refunds as of April 5, for a total of \$183 billion. The average refund thus far is \$2,436. In addition, nearly 28 million taxpayers have tracked their refund on IRS.gov, up nearly 20 percent over last year.

As of March 29, our Taxpayer Assistance Centers (TACs) are reporting over 2.1 million taxpayers assisted. Our telephone assistants have answered over 13 million calls, and over 17 million callers received automated services.

#### *Free File*

Over 3.6 million people have utilized Free File as of April 5, 2008, an increase of 19.7 percent compared to the number of taxpayers that used Free File during the same period a year ago. This year anyone with adjusted gross income of \$54,000 or less is eligible for Free File, which includes 97 million taxpayers. The number of Free File returns compared to the prior year has been steadily increasing, and we expect to meet or exceed 2007 totals by the end of the filing season. One reason

for this increase is that we have committed additional resources to promote the Free File program.

*VITA/TCE Sites and Other Community Partnerships*

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased over the years. In 2007, over 2.6 million returns were prepared by volunteers. As of April 5, 2008, volunteer return preparation is up over 26 percent compared to the number of volunteer-prepared returns filed during the same period a year ago. This is reflective of continuing growth in existing community coalitions and partnerships.

We also have made a concerted effort to expand outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored again this year EITC Awareness Day on January 31, 2008, in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge them to claim the credit. Over 125 coalitions and partners hosted local news conferences and issued more than 100 press releases highlighting EITC Awareness Day this year.

A COMMITMENT TO SERVICE, ENFORCEMENT AND MODERNIZATION

I understand that in fiscal year 2007, the IRS continued making improvements in our service and enforcement programs as well as having significant successes in our IT modernization program. A few highlights of the IRS' fiscal year 2007 accomplishments include:

- The IRS customer assistance call centers answered 33.2 million assistor telephone calls and 21.1 million automated calls. We maintained an 82.1-percent level of service on the telephone with an accuracy rate of 91.2 percent on tax law questions.
- Outreach and educational services were enhanced through partnerships between the IRS and public organizations. Through its 11,922 VITA and TCE sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. Over 76,000 volunteers filed 2.63 million returns for these individuals. Additionally, the IRS established 6 new tax clinics in rural areas to help low-income taxpayers meet their tax obligations.
- Enforcement revenue has risen from \$33.8 billion in fiscal year 2001 to \$59.2 billion, an increase of 75 percent. These numbers do not include the deterrent effect that an increased enforcement presence has on voluntary compliance.
- Both the levels of individual returns examined and coverage rates have risen substantially. The IRS conducted nearly 1.4 million examinations of individual tax returns in fiscal year 2007, an 8-percent increase over fiscal year 2006. This level of examinations is over three-quarters more than were conducted in fiscal year 2001, and reflects a steady and sustained increase since that time. Similarly, the audit-coverage rate has risen from 0.6 percent in fiscal year 2001 to 1 percent in fiscal year 2007. This increase was achieved without a significant increase in resources as compared to the previous fiscal year.
- The Customer Accounts Data Engine (CADE) Release 3.2 was delivered on time (January 14, 2008) for this filing season and is doing well in production. As of April 11, CADE had processed 24.98 million returns, which is more than 25 percent of all individual returns filed to date for this year. CADE also has issued almost \$38 billion in tax refunds.
- Modernized e-File (MeF) is the IRS designated e-File platform (electronic filing system) for the future and provides e-Filing capability for large corporations, small businesses, partnerships, and non-profit organizations. As of April 5, MeF has accepted 1.82 million corporate, partnership, and tax exempt tax returns, a 45-percent increase from this same period a year ago. MeF Release 5 went into production as planned in January 2008 and provides the ability to file electronically Form 1120F (tax returns for foreign corporations) and Form 990N (so-called electronic postcard for small tax-exempt organizations to meet their filing requirement).

THE ADMINISTRATION'S FISCAL YEAR 2009 BUDGET FUNDS TAXPAYER SERVICE AND ENFORCEMENT

The fiscal year 2009 budget request funds activities that promote better tax administration and compliance with the tax laws. The fiscal year 2009 budget request for the enforcement program is \$7,487,209,000, an increase of \$489,983,000, or 7 percent, over the fiscal year 2008 enacted level. The Administration proposes to in-

clude these enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The enforcement program is funded from the Enforcement appropriation and part of the IRS Operations Support appropriation.

#### *Budget Request*

For fiscal year 2009, the President is requesting a total of \$11,361,509,000 for IRS activities. This amount is a \$469,125,000 increase, or 4.3 percent, over the fiscal year 2008 enacted level.

The overall IRS budget is broken down into the following five appropriations:

—*Taxpayer Services*.—The fiscal year 2009 requested level for this area is \$2,150,000,000. This is the same as the fiscal year 2008 enacted level. The Operations Support account provides an additional \$1.5 billion to support taxpayer service activities.

—*Enforcement*.—The fiscal year 2009 request is \$5,117,267,000. This level is an increase of 7.1 percent from the fiscal year 2008 enacted level. As mentioned earlier, the Operations Support budget provides an additional \$2.4 billion to support enforcement activities.

—*Operations Support*.—The fiscal year 2009 request is \$3,856,172,000. This level is an increase of 4.8 percent from the fiscal year 2008 enacted level.

—*Business Systems Modernization*.—The fiscal year 2009 request is \$222,664,000. This level is a reduction of 16.6 percent from the fiscal year 2008 enacted level. This appropriation funds the planning and capital asset acquisition of information technology to modernize the IRS business systems, including labor and related contractual costs.

—*Health Insurance Tax Credit Tax Administration*.—The fiscal year 2009 request for this program is \$15,406,000. This is an increase of 1.1 percent from the fiscal year 2008 enacted level. This appropriation funds costs to administer a refundable tax credit for health insurance to qualified individuals, which was enacted as part of the Trade Adjustment Assistance Reform Act of 2002.

The justification for the requests in each of these areas is discussed in detail below.

#### *Adjustments from Fiscal Year 2008 Levels To Help Improve Compliance*

The IRS total requested funding increase for fiscal year 2009 is \$469,125,000. This increase will go to improving compliance. These investments fund increased front-line enforcement efforts, enhanced research, and implementation of legislative proposals to help narrow the tax gap. By fiscal year 2011, these investments are projected to increase annual enforcement revenue by \$2 billion. In addition, the legislative proposals included in the fiscal year 2009 budget to improve tax compliance are estimated to generate \$36 billion over the next ten years, if enacted.

Specific increases to improve compliance include:

—*Reduce the Tax Gap for Small Business and the Self Employed (+ \$168,498,000 / + 1,608 FTE)*.—This enforcement initiative will increase enforcement efforts to improve compliance among small business and self-employed taxpayers by: increasing audits of high-income returns, increasing audits involving flow-through entities, implementing voluntary tip agreements, increasing document-matching audits, and collecting unpaid taxes from filed and non-filed tax returns. This request will generate \$981 million in additional annual enforcement revenue once new hires reach full potential in fiscal year 2011.

—*Reduce the Tax Gap for Large Businesses (+ \$69,488,000 / + 519 FTE)*.—This enforcement initiative will increase examination coverage of large and mid-size corporations, including multi-national businesses, foreign residents, and smaller corporations with significant international activity. It also will enable the IRS to use existing systems further to capture other electronic data through scanning and imaging. The initiative will allow the IRS to address risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for non-compliance is significant. Funding of this request will generate \$544 million in additional annual enforcement revenue once the new hires reach full potential in fiscal year 2011.

—*Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance (+ \$51,058,000 / + 393 FTE)*.—This enforcement initiative will support and expand ongoing research studies, including the National Research Program, of filing, payment, and reporting compliance to provide a comprehensive picture of the overall taxpayer compliance level. Research allows the IRS to target better specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. Improved research data will be used to refine workload selection models, reducing audits of compliant taxpayers.

- Increase Reporting Compliance of U.S. Taxpayers with Offshore Activity (+\$13,697,000/+124 FTE).*—This enforcement initiative will address domestic taxpayer offshore activities. Abusive tax schemes, under-reporting of flow-through income, and certain high-income individuals are prime channels or candidates for tax evasion. This initiative will focus on uncovering offshore credit cards, disguised corporate ownership, and brokering activities in order to identify individual taxpayers who are involved in offshore arrangements that facilitate noncompliance. Funding of this request will generate \$102 million in additional annual enforcement revenue once the new hires reach full potential in fiscal year 2011.
- Expand Document Matching (+\$35,060,000/+413 FTE).*—This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program. This program matches third-party information returns (e.g., Form W-2 and Form 1099 income reports) against income claimed on tax returns. When potential underreporting is discovered taxpayers are contacted to resolve the issue. This request will produce \$359 million in additional annual enforcement revenue once the new hires reach full potential in fiscal year 2011.
- Implement Legislative Proposals To Improve Compliance (+\$23,045,000/0 FTE).*—While the IRS continues to address compliance by improving customer service and using traditional methods of enforcement, the fiscal year 2009 budget also includes legislative proposals that would provide additional enforcement tools to improve compliance. It is estimated that these proposals, if enacted, will generate \$36 billion in revenue over 10 years (see the Treasury Blue Book, available on the Treasury Department web site, for more information). The proposals would expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties. This enforcement initiative includes funding for purchasing software and making modifications to the IRS IT systems necessary to implement the proposals. The specific legislative proposals are discussed below.

#### *Specific Legislative Proposals*

The Administration's fiscal year 2009 budget includes a number of legislative proposals intended to improve tax compliance while minimizing the burden on compliant taxpayers as much as possible. These include:

- Expand information reporting.*—Compliance with the tax laws is highest when payments are subject to information reporting to the IRS. Specific information reporting proposals would:
  - Require information reporting on payments to corporations;
  - Require basis reporting on security sales;
  - Require information reporting on merchant card payment reimbursements;
  - Require a certified Taxpayer Identification Number (TIN) from contractors;
  - Require increased information reporting on certain Government payments;
  - Increase information return penalties; and
  - Improve the foreign trust reporting penalty.
- Improve compliance by businesses.*—Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:
  - Require electronic filing by certain large organizations; and
  - Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes.
- Strengthen tax administration.*—The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:
  - Expand IRS access to information in the National Directory of New Hires for tax administration purposes;
  - Permit disclosure of prison tax scams;
  - Make repeated willful failure to file a tax return a felony;
  - Facilitate tax compliance with local jurisdictions;
  - Extend statutes of limitations where State tax adjustments affect Federal tax liability; and
  - Improve the investigative disclosure statute.
- Expand penalties.*—Penalties play an important role in discouraging intentional non-compliance. A specific proposal to expand penalties would impose a penalty on failure to comply with electronic filing requirements.

#### *Improve Tax Administration and Other Miscellaneous Proposals*

The Administration has put forward additional proposals relating to IRS administrative reforms. Five of these proposals are highlighted below:

- The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.
- The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.
- The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding \$50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.
- The fourth proposal extends the IRS authority to use the proceeds received from undercover operations through December 31, 2012. The IRS was previously authorized to use proceeds it received from undercover operations to offset necessary and reasonable expenses incurred in such operations. This authority expired on December 31, 2007.
- The fifth proposal equalizes penalty standards between tax return preparers and taxpayers, reducing unnecessary conflicts of interest between them. The standard applicable to tax return preparers for undisclosed positions would be “substantial authority” but for certain reportable transactions with a significant purpose of tax avoidance, the existing standard would persist (i.e., the preparer should have a reasonable belief that the position, more likely than not, would be sustained on the merits).

#### CONCLUSION

Thank you again, Mr. Chairman, for the opportunity to appear this morning and update the subcommittee on the filing season and the fiscal year 2009 proposed IRS budget. In my short tenure, I have found IRS employees to be professional, hard-working, and dedicated.

I am committed to working hard everyday to provide taxpayers the high level of service they deserve and to pursue enforcement actions against those unwilling to meet their tax obligations.

We need resources to execute against our plan, and I hope this subcommittee will support the full funding of the Administration’s fiscal year 2009 proposed budget.

I also urge this subcommittee to support the enactment of the legislative proposals included in the budget to improve compliance. Collectively, they will generate more \$36 billion over the next 10 years if enacted.

I will be happy to respond to any questions.

#### CONTRACTORS

Senator DURBIN. In preparation for this hearing, I am hoping that you have read Parade magazine in last Sunday’s newspaper because my first question relates to enforcement and an article in that Parade magazine. It was under their so-called intelligence report entitled “Are You Paying for Corporate Fat Cats?” 61 percent of U.S. corporations paid no taxes, including 39 percent of large companies, according to this article. They went on to describe one company in particular, which I would like to ask you about.

It turns out that one company employs one-third of our private contractors in Iraq. That company is Kellogg, Brown & Root (KBR), a former subsidiary of Halliburton. The company has 54,000 people working in Iraq. Of these, over 21,000, including 10,500 Americans, are considered Cayman Island hires. What has happened is that this company has created some subsidiaries or offices in the Cayman Islands, and by listing these employees paid by our Government as Cayman Island hires, they avoid paying the Medicare and Social Security taxes that all other American workers pay.

So here we have Federal taxpayer dollars, emergency appropriations adding to our deficit to fund the private contractors who are being channeled through the Cayman Islands so that they will not

have to pay taxes into the United States for Medicare and for Social Security. I want to know if the IRS is looking into it, and I want to know what more we can do to try to stop this.

Mr. SHULMAN. Thank you for the question. Let me just state before I start, I obviously cannot speak about any specific taxpayers or any tax matters because of privacy laws. Let me just react on a general level, and then we would be happy to follow up.

We are well aware and focused on the issue of independent contractors. Employment taxes are one of our responsibilities. Any issue with employment taxes is very fact-specific. We have a 20-point factor test that gets into the specific facts of a case. It is difficult for corporations and us to work through these issues, but we have a number of investigations ongoing in relation to employment taxes and subcontractors, and we view that as part of our job.

I would also mention something I have spoken about publicly is that one of the challenges of our next 5 years is going to be grappling with the global economy, globalization, international tax issues. I have sat down with our team that focuses on these areas. I am quite familiar with these issues from my experience as a securities regulator and the global flow of capital. So issues around cross-border trade, employees located in multiple countries, paying the proper amount of U.S. taxes is something that is going to get focus from me.

Senator DURBIN. And I might say that it is not just KBR. A 2004 study by the Government Accountability Office found that 24 of the largest Federal contractors, contractors we pay by our Government, use the Cayman Islands to shave their tax bills. This bothers me that American companies doing the right thing are being penalized and other companies are profiting simply because they are creating these phony tax havens like the Cayman Islands.

#### PRIVATE DEBT COLLECTION

Now let us talk for a minute about an issue that you have been asked a lot about, and that is this private collection agency for the IRS. This has been in place for a while now, these private debt collectors. There are several of them across the country, and they are not doing a very good job. If you take a look at our own IRS employees collecting taxes, the return on investment for taxpayers is 13 to 1. For the private collectors, it is only 3 to 1. To date, after spending \$71 million on startup and ongoing maintenance costs through the end of fiscal year 2007, the IRS private tax collection program has lost us \$50 million.

Why should we continue this?

Mr. SHULMAN. This is an issue that I understand quite well has a lot of attention, and there are people who support the program and detractors from the program. I have committed to get my arms around this. As you can imagine, there are a variety of programs, most programs, that I still need some time to get up to speed on, and I am going to spend time getting up to speed on this.

What I will tell you is I know the program has been authorized in the past by Congress. I have been told by the people at the IRS that they are working this program to the best of their abilities. We are very focused on the protection of taxpayer rights and data privacy. This year the program will do better than break even, and

so there are variety of sunk costs that have not been recovered, but it is now at a point where it actually is bringing dollars into the Federal coffers.

So on this one, I would say I plan on looking at it closely and studying the issue and would be happy and like to have further conversations.

Senator DURBIN. Thank you.

#### FORMS AND COMPLEXITY

Senator Brownback.

Senator BROWNBACK. Thank you, Mr. Chairman.

Do you really need 800 different forms?

Mr. SHULMAN. As we have had a chance to discuss, clearly the tax law is complex. Clearly, that adds burden on the American people and makes our job difficult. I cannot speak to all the specific forms 4 weeks into the job.

I will tell you a goal of mine is to create as much clarity as we can within the context of the law to the American people, make it as easy as possible, given the complexity of the law, for the American people to comply with their tax obligation.

Senator BROWNBACK. I hope you will look at that. That is just mind-boggling to me.

I was just looking at the numbers that were just handed to me. The IRS spends \$2 billion on taxpayer service helping people figure out their taxes. It is estimated that taxpayers spend \$150 billion to figure out their taxes, either hiring third parties or in time taken away from other activities. \$150 billion that people are spending to figure out their taxes. That is amazingly high.

Do you have any sense of how that compares to other countries in the developed world?

Mr. SHULMAN. I do not, Senator.

Senator BROWNBACK. You have now got a growing set of countries that have moved to a flat tax. I think there is something like 16 that have gone to that system. I think it would be an interesting question to look at, what those countries spend in tax preparation time and money versus other places.

#### STIMULUS PAYMENTS

Are you going to have any difficulty getting the economic stimulus checks out on time?

Mr. SHULMAN. Since I have started the job, obviously this is something I am very focused on. Three times a week I have been in meetings with our staff. Everything looks like it is on track to have direct deposit checks go out the first week in May—start going out—and paper checks start going out shortly thereafter. So from everything I know, being in here 4 weeks, things look like they are on track to get the stimulus payments out on time.

Senator BROWNBACK. And to hit the dates?

Mr. SHULMAN. Hit the targets that are on our web site that we have promised all along.

Senator BROWNBACK. You have said that you have spent a lot of time getting people signed up to file tax forms so they could get their stimulus check. Did you get a number of new registrants fil-

ing tax returns? I believe you had a special super Saturday, March 29, to do this?

Mr. SHULMAN. We did something I am quite proud of, and it was a great way to start my first Saturday on the job. I went out to a retired veterans home and worked with our team. And we had 700 sites around the country open that Saturday, staffed with about one-half IRS and one-half volunteers. That day we had over 50,000 come into that combined group of sites.

We are tracking very closely people who we think are only filing for stimulus payments. Yesterday we just got all the 2007 returns. We are still processing paper returns. Later this month, we are actually going to look at the number of returns, try to figure out who we think is eligible, who has not filed yet, and then do another round of outreach. Our plan is actually to enlist both the administration and Members of Congress, if we see States where it looks like a lot of people have not availed themselves of the stimulus payments. We are going to be doing outreach and we will try to bring you in, as well, as partners.

Senator BROWNBAC. I do not know if many Members of Congress want to be very closely associated with the IRS, but maybe if it is passing checks out, that would change it.

Do you have any idea of numbers of what you are talking about here? I see your activities, but do you have any idea on numbers?

Mr. SHULMAN. We do not. It is very hard to estimate how many people are eligible. We are going to have a much better sense at the end of this month, and I can assure you our team will work on it. I have been pushing on this, and we are going to, hopefully by the end of the month, have a real sense of how many have come in and how many we think might still be eligible, based on Social Security rolls and other sources, and go out to more people.

Senator BROWNBAC. Will you be publishing, putting those numbers forth publicly?

Mr. SHULMAN. We would be happy to share them with you.

Senator BROWNBAC. I think it would be good just because we are all very concerned about the economy, how many people are going to get checks, or an estimate?

Mr. SHULMAN. Well, I am sorry. I might have misspoken. I was talking about the people who normally do not file who are eligible. We do have estimates of the broad numbers. We anticipate sending out over \$100 billion in stimulus payments this year to over 130 million taxpayers. That is the gross number. We have not pinpointed the people who may be eligible who otherwise would not file a tax return, which is a group that we are very focused on providing service to.

Senator BROWNBAC. My time is up, but that is the number I was asking for, the number of people that you think would qualify but are not in the system getting or are not signed up, in your estimation who that would be? I would like to see if we could get that number.

Mr. SHULMAN. Absolutely.

Senator DURBIN. Senator Allard.

#### CONSERVATION EASEMENTS

Senator ALLARD. Thank you, Mr. Chairman.



I want to pursue my opening comments on the conservation easements of Colorado. It is my understanding in mid-November, the Internal Revenue Service began making settlement offers to a significant number of conservation easement donors under audit in Colorado. According to your agency, the settlements were only offered in those cases where the sole issue between the owner and the Internal Revenue Service was the valuation. The offers generally fell into a bucket where the IRS stated only 30 percent or 60 percent or 75 percent of the original value of the charitable donation was allowed.

And the question I have is, what were the criteria that you used to place different taxpayers into these various buckets, and did the IRS indicate in writing to the donor how and why you arrived at your decision, and if not, why?

Mr. SHULMAN. Senator, I understand this issue. I had the opportunity to speak with your colleague from Colorado, Senator Salazar, at length about this issue. And what I shared with him I will share with you. I have also done some research on this, knowing that this would be of issue to you.

My belief is that our job is to implement the tax laws in a way that achieves the intent of the policy that Congress puts forward, and so I share your goal that you talked about. The goal for quality of life and open space in Colorado is what we should be pursuing, which means we should make sure that we do not unduly restrict people trying to do the right thing and donate open space.

I have been briefed on this issue, and I will tell you what I know. And I would like to come back with Steve Miller for anything I do not know, and meet with you and continue to pursue this.

Since last fall, there has been some good progress, and 170 offers have been made. The numbers I was given were higher than the ones you just discussed, and so I have to dig into it more. But I understand that, in general, these 170 offers across the board—the general number was in the 70 percent range of the tax deduction that people had looked for. So it was a little higher.

Senator ALLARD. I just want to clarify for the record. You determined that it was overvalued by 70 percent. Is that what you said?

Mr. SHULMAN. No, that people were offered 70 percent of their original claim. So if they claimed \$100, they were——

Senator ALLARD. You said, well, we will give you \$70.

Mr. SHULMAN. \$70—and that is in aggregate of these offers—is the number as I understand.

Senator ALLARD. Got you.

Mr. SHULMAN. I also know that you requested that we be liberal in granting extensions of time for people to analyze offers and come back, and the Service was responsive to that.

And I have been told that 20 to 25 more offers will go out in the next several weeks.

These offers were the valuation cases. There are a number of much more complex cases that were put behind the valuation cases to move forward. They are very fact-intensive. We are coordinating with the State of Colorado on all of those. So there is some time around coordination and these will take some more time.

Let me also tell you that the people running this program have told me they understand the frustration that you have around the

length of time this has taken, and that they are not happy with the pace and would like to pick up the pace. They actually asked me for some more resources for appraisers, and it is something that I authorized today to try to move this backlog through. As I said, I believe we need to be thorough, but we also need to be expeditious, so people can get on with their business.

Regarding the exact criteria, I have talked to the team about the program. I have not talked about any specific cases. I am 4 weeks into the job. I would like to request, if I could, to come back and talk with you.

What I will tell you is I believe we need to move the backlog. I have requested and authorized to put some more appraisers onto these cases, and I will be focused on it. I have told your colleague Senator Salazar that as well.

Senator ALLARD. Well, we are interested in seeing—you certainly have general criteria that you come to in doing your appraisals, and we would like to look at the qualifications of your appraiser on land values in Colorado particularly and have a concern about where maybe the Colorado Department of Revenue has already done a lot of the investigation, I hope you are not duplicating what they do. Maybe you can just assume that they have done a pretty good job and you follow with that and maybe save some time and expedite some of these jobs. And if you feel like you cannot, I would like to know why you feel like the State of Colorado is not doing an adequate job, and you need to go ahead and do that.

So I have a list of questions here, and my time is expired here. So we would like to get those to you and then you can review them and get back and give us some detail on where we are on getting this process moving forward in Colorado. Thank you.

Mr. SHULMAN. Thank you.

Senator ALLARD. Thank you, Mr. Chairman.

#### MISCLASSIFICATION OF WORKERS

Senator DURBIN. Thanks, Senator Allard.

Commissioner Shulman, this may have been done before you arrived, but the IRS prepared 16 legislative proposals and several administrative proposals for closing the tax gap with their 2009 budget submission. The one that is missing is a pretty big one. It is the misclassification of workers. It accounts for \$148 billion in lost taxes each year. It represents 43 percent of the gross tax gap that we face as a country. It relates to people who call themselves independent contractors and evade payment of taxes that they are duly owing to the Federal and State government.

So I would like to ask you if you are familiar with this issue, if you know of any initiatives underway, if you can explain why it was not included as one of the proposals to close the tax gap.

Mr. SHULMAN. I was not here when that tax gap proposal, the general one, was put together, although I have studied it and I support moving forward with those proposals. I was also asked a lot about the tax gap during my confirmation hearing with the Senate Finance Committee. And I have made a commitment to take a fresh look at the tax gap and at least engage in a dialogue. And some of the tax gap issues have political consequences, as well as administrative consequences, which are going to be beyond the

IRS's purview, but my promise is to study it, come to my conclusions, and at least engage in that dialogue.

I do not want to answer your question wrong. I mean, my focus, and what I believe, is that a huge part of the tax gap is small business, pass-through business, and self-employed. And I have looked at that issue and am a big supporter of at least having the dialogue around information reporting and other issues around there. All of the studies I have done around the tax gap show that where there is withholding, there are the highest levels of compliance. Where there is information reporting, so people know that someone else is reporting information about them, there is the next highest level, and where there is no reporting and it is just on the honor system, there is a lower level of compliance, although a lot of people—most Americans—want to pay their fair share, and do pay their fair share, in taxes.

So I think that is what you are referring to. If not, I apologize for not being responsive.

Senator DURBIN. That is, and I will certainly give you time to take a look at that. A little more time.

Senator Brownback.

#### STIMULUS PAYMENTS

Senator BROWNBACK. Yes. On the next panel, one of the testimonies will be from the National Taxpayer Advocate, Nina Olson. I was just looking at her testimony. They were saying that you are planning on tax rebate checks to the 130 million taxpayers who file income tax returns, but also you must identify and process returns from and payments to more than 20.5 million people who have no filing requirement, yet are qualified for a tax rebate. That was just the number that has come out of this testimony. And if that is the case, that is a big number you are going to need to hit in pretty short order.

Mr. SHULMAN. Yes. That number—let me speak to that. I was hesitant to throw that one out because that was the gross estimate early on in the process. That does not take into account potentially eligible people on Social Security who are married, but who are not both eligible. So that number would be drawn down. It does not take into account dependents or people who are claimed as dependents on other forms. So I think that was the early gross estimate. We are going to have a much better sense once we get the filed numbers in.

Let me also just tell you, there are a variety of reasons—when I was out at the retired veterans home, there are a lot of people who are not part of the system and have not filed a return and might not want to file a return.

Senator BROWNBACK. They are not interested in being part of the system. I understand that.

Mr. SHULMAN. Yes, to get their \$300 check.

So we are very focused on doing everything the IRS can do. I understood your comment about maybe not wanting to go out with us and publicize this, but we are going to try to be creative, once we see these numbers, about enlisting as many people as we can to get the word out.

Senator BROWNBACK. It is just that everybody is concerned about the economy. This was a big bipartisan push by the Congress and the administration to get this done. So we want as broad a reach as possible, and 20 million is a large number of people. But also I understand what you are saying about not everybody wanting to be in the system. Still, getting all those checks out is going to take a lot of work and you are on a short tether to get it done in the time period you are talking about.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Mr. Commissioner. I appreciate it very much.

And we are now going to invite panel number 2 to be seated. The panel includes Mr. J. Russell George, Mr. Paul Cherecwich, and Ms. Nina Olson. They have submitted extensive written statements, and Senator Brownback and I would appreciate it if they would do their best to confine themselves to 5-minute statements. Any statement that goes beyond 5 minutes, they will be presumed guilty and subject to penalties and interest.

Mr. George, how would you like to start?

**STATEMENT OF J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, DEPARTMENT OF THE TREASURY**

Mr. GEORGE. Thank you, Chairman Durbin, Ranking Member Brownback. I appreciate the opportunity to testify on the Internal Revenue Service's fiscal year 2009 budget.

As you heard from the Commissioner, the IRS's proposed fiscal year budget requests approximately \$11 billion in direct appropriations. This amount is approximately a 4.3 percent increase over its fiscal year 2008 budget. The 2009 budget request seeks an increase of \$337 million for enforcement. Meanwhile, funding for taxpayer services remains virtually the same as the 2008 appropriation. Funding for the business systems modernization project is reduced by more than 16 percent.

The previous Commissioner of Internal Revenue frequently stated that taxpayer service plus enforcement equals compliance. The budget request provides a 7 percent increase for the IRS's enforcement activities. As you are well aware and noted earlier, our Nation has a tax gap estimated to be grossly about \$345 billion per year. A vital component of the effort to reduce the amount requires the IRS to take steps to ensure that everyone who owes Federal taxes pays their debt.

The fiscal year 2009 budget request seeks nearly \$361 million in program increases for IRS enforcement initiatives. This amount accounts for 77 percent of the agency's overall funding increase. Part of the enforcement initiative funding would allow the Service to hire just over 3,000 new enforcement and operation support employees. The IRS estimates that these new employees will help generate more than \$2 billion in additional annual enforcement revenue by fiscal year 2011.

In addition to hiring new employees, IRS enforcement initiatives will focus on enhancing activities targeted at improving compliance. The budget request supports this by proposing funding to reduce the tax gap for large and small businesses, as well as the self-employed, increase compliance of domestic taxpayers with offshore

activity, and minimize revenue loss by increasing document matching efforts.

The initiatives also include increased support for research to better understand the reasons for taxpayer noncompliance and implementation of legislative proposals to improve compliance.

It is noteworthy that the 2009 budget request does not seek additional funding for any taxpayer service initiatives above the 2008 funding levels. This was of concern to the Treasury Inspector General for Tax Administration (TIGTA). As you know, at the request of this subcommittee and Congress as a whole, the IRS has expended considerable resources to develop the taxpayer assistance blueprint. Many of the blueprint's initiatives would provide IRS customers with services similar to those that they are accustomed to receiving from private financial organizations such as online access to their accounts.

The IRS must continue to determine the kinds of assistance taxpayers want and need to ensure that the blueprint strategy is effectively implemented to meet those demands. However, most of these initiatives were not funded in 2008 and would remain unfunded in fiscal year 2009.

A key component of any success the IRS would hope to achieve in providing better service, as well as increased enforcement, is its business systems modernization effort. The modernization program has been a long-term challenge for the IRS. The 2009 budget request cuts funding for projects that are at the heart of the IRS's efforts to replace its antiquated computer systems. The program is in its 10th year and has paid out approximately \$2.5 billion for contractor services. In addition, the IRS has spent \$265 million through fiscal year 2007 in internal IRS costs and plans to spend an additional \$223 million on a program in fiscal year 2008.

According to the IRS's original plan, the modernization program should have been past the halfway point this year. Although the IRS has made advances in the effort, it has not progressed as anticipated. While the IRS has improved its project management and contract oversight, the program remains behind schedule, over budget, and is not delivering what was promised.

For example, the IRS originally planned to complete the replacement of its individual master file with the customer accounts data engine in 2005. The current estimated completion date for this replacement is the year 2012.

In January 2005, the Government Accountability Office designated business systems modernization as a high-risk area. One reason for that designation is that the IRS's new systems need to include adequate audit trails to capture improper intrusions and unauthorized transactions.

Consistent with recommendations made by TIGTA in the past, the IRS has narrowed its efforts and is focused on three of its most important projects: the customer accounts data engine, the accounts management services, and the modernized e-file program. At this time, TIGTA does not know what impact the cuts on the modernization budget may have on these programs. The IRS declined to provide TIGTA with that information.

The final issue I will discuss—I beg your indulgence, Mr. Chairman—is the impending retirement wave. Thirty percent of the

IRS's current employees will be eligible to retire within the next 2 years, while nearly 40 percent of its executives are currently eligible to retire. GAO has designated human capital as a high-risk Government-wide concern. TIGTA has also designated the strategic management of human capital as one of the IRS's major management challenges. The loss of institutional knowledge places several of the IRS's critical projects at great risk, including the multiyear, multi-billion dollar effort to modernize its technology and related business processes.

It is vital that the IRS effectively implement the human capital strategies listed in its fiscal year 2009 budget request. Not only will the IRS need to place significant focus on recruiting, it will need to ensure that the new employees reach their full potential. At the same time, the IRS will need to retain its more experienced employees and capture the knowledge of those who leave the IRS.

Mr. Chairman, Ranking Member Brownback, thank you for your indulgence. I hope my discussion will help you in your deliberations.

Senator DURBIN. Thank you, Mr. George.

[The statement follows:]

PREPARED STATEMENT OF THE HONORABLE J. RUSSELL GEORGE

Chairman Durbin, Ranking Member Brownback, and Members of the subcommittee, thank you for the opportunity to testify today. My comments will focus on the Internal Revenue Service's (IRS) fiscal year 2009 budget and, at your request, the Treasury Inspector General for Tax Administration's (TIGTA) fiscal year 2009 budget request. I will also briefly comment on the status of the 2008 Filing Season.

The IRS administers America's tax laws and collects approximately 95 percent of the revenues that fund the Federal Government. The IRS has four major components: the Wage and Investment Division, the Small Business/Self-Employed Division, the Large and Mid-Size Business Division and the Tax Exempt and Government Entities Division. Together, these divisions are largely responsible for collecting more than \$2 trillion in tax revenues each year. At a time when our Nation is at war, it is imperative to identify the resources required to support the IRS's role as steward of the country's tax administration system.

The IRS must continue to address management and operational issues, including modernization of its computer systems, addressing the tax gap, protecting taxpayer rights, and ensuring the security of its resources. To that end, the IRS has requested \$11.4 billion to fund the agency's operations for fiscal year 2009. This is a 4.3 percent increase over the 2008 enacted budget. The IRS's fiscal year 2009 budget request for systems modernization is \$40 million less than the fiscal year 2008 enacted amount. The IRS does not specify which programs will absorb these costs, only that the requested amount will allow continued progress on key modernization projects. However, millions of taxpayers entrust the IRS with sensitive financial and personal data stored and processed by its computer systems. The IRS faces enormous challenges in securing this vast amount of personally identifiable information, including ensuring that all systems have sufficient controls to prevent and detect intrusions and improper accesses.

The budget request includes a 7 percent increase for enforcement and less than a 1 percent increase for taxpayer service. In 2007 the IRS finalized strategies to reduce the tax gap and improve customer service.<sup>1</sup> The IRS is in the preliminary stages of both strategies. Determining what role taxpayer service plays in increasing voluntary compliance and reducing the tax gap will continue to be a challenge in the near future. The IRS must strive to enforce the tax laws fairly and efficiently while balancing service and enforcement to promote voluntary compliance and reduce taxpayer burden.

<sup>1</sup>*Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (Washington, D.C.: Aug. 2, 2007); *The 2007 Taxpayer Assistance Blueprint Phase 2* (Washington, D.C.: 2007).

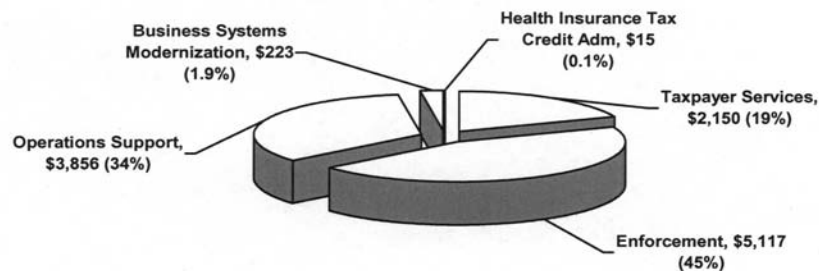
## OVERVIEW OF THE IRS'S FISCAL YEAR 2009 BUDGET REQUEST

The proposed fiscal year 2009 IRS budget requests approximately \$11.4 billion in direct appropriations, \$107.9 million from reimbursable programs, and \$177.7 million from user fees. The direct appropriation is approximately a \$469.1 million increase (4.3 percent) over the fiscal year 2008 enacted level of \$10.9 billion.

In fiscal year 2008, the IRS requested a budget of approximately \$11.1 billion, an increase of \$498 million (4.7 percent) over its fiscal year 2007 spending authority. The amount enacted by Congress for fiscal year 2008 was \$203 million (1.8 percent) less than the budget request. Congress also made substantial changes in budget priorities in fiscal year 2008 by increasing the Taxpayer Services appropriation by \$46.9 million above the IRS's request while cutting the Administration's Enforcement and Operations Support appropriation requests by a total of \$235 million. The budget request also included a net increase in the overall size of the IRS of nearly 1,800 Full-Time Equivalent<sup>2</sup> employees.

The fiscal year 2009 IRS budget request includes appropriations for five IRS budget accounts (categories): Enforcement, Operations Support, Taxpayer Services, Business Systems Modernization, and the Health Insurance Tax Credit Administration (see Figure 1).

**Figure 1: IRS Fiscal Year 2009 Budget Request  
(in millions)**



Source: TIGTA analysis of Fiscal Year 2009 IRS Budget Request by IRS Budget Accounts.

Within these appropriation accounts, the IRS seeks to increase funding for Enforcement, Operations Support, and the Health Insurance Tax Credit Administration while decreasing funding for Business Systems Modernization (Modernization). The budget request seeks an Enforcement Appropriation of \$5.12 billion, an increase of \$337 million (7.1 percent) over the current fiscal year 2008 appropriation of \$4.78 billion. The funding for Taxpayer Services remains the same as the fiscal year 2008 enacted level.

The Modernization program is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system.

The Modernization program is in its 10th year and has received approximately \$2.5 billion for contractor services. Additionally, the IRS had spent \$265 million through fiscal year 2007 for internal IRS costs, and plans to spend an additional \$223 million on the program in fiscal year 2008. According to the IRS's original plan, the Modernization program should be past the halfway point in Calendar Year 2008. However, the IRS has not completed as many Modernization projects as planned because it has received less funding than initially anticipated and has had difficulties in managing the scope and complexity of the work. For example, the Customer Account Data Engine (CADE) is the foundation of the Modernization program. The IRS originally planned to complete replacement of its Individual Master

<sup>2</sup>A Full-Time Equivalent is a measure of labor hours. One Full-Time Equivalent is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year.

File with the CADE in 2005.<sup>3</sup> The current estimated completion date for this replacement is 2012.

Although the IRS has made advances in its Modernization effort, it has not progressed as anticipated. TIGTA has reported that inconsistent compliance with project development controls has contributed to delays in project deliveries, increased development costs, and reduced capabilities.<sup>4</sup> Since fiscal year 2002, TIGTA's Modernization program annual assessments have cited the following four specific challenges the IRS needs to overcome to deliver a successful modernization effort:

- Implement planned improvements in key management processes and commit necessary resources to enable success;
- Manage the increasing complexity and risks of the Modernization program;
- Maintain the continuity and strategic direction with experienced leadership; and
- Ensure that contractor performance and accountability are effectively managed.

Accordingly, because solutions to the IRS's serious and intractable financial management problems largely depend upon the success of its Modernization efforts, in January 2005 the financial management risk was combined with the Modernization risk into the Business Systems Modernization high-risk area.<sup>5</sup> Modernization remains a high risk for the IRS. One reason is that all of its new systems need to include adequate audit trails.

For fiscal year 2008, the IRS requested funding of approximately \$222.7 million for Modernization, a cut of 16.6 percent (\$44.4 million from the \$267.1 million enacted). This cut is expected to eliminate at least 25 employees. However, the fiscal year 2008 enacted amount was an increase of \$54.4 million (25.6 percent) from the \$212.7 million enacted for fiscal year 2007.

The fiscal year 2009 budget request does not specify which programs will absorb the cuts, although it states that the requested amount will allow continued progress on key modernization projects, including the CADE, Accounts Management Services (AMS), and Modernized e-File (MeF). However, the Government Accountability Office (GAO) recently issued a report that included proposed spending by major project.<sup>6</sup> Figure 2 shows the funding proposed for major Modernization projects in fiscal year 2009 compared to the amounts enacted for fiscal year 2008:

FIGURE 2.—BUSINESS SYSTEMS MODERNIZATION PROJECTS IN FISCAL YEAR 2009 IRS BUDGET REQUEST

[In millions of dollars]

Project	Fiscal year 2008 enacted	Fiscal year 2009 budget request	Change from fiscal year 2008 enacted
Customer Account Data Engine .....	58.5	58.8	0.3
Accounts Management Services .....	29.0	26.2	(2.8)
Modernized e-File .....	55.8	25.0	(30.8)
Core Infrastructure .....	39.2	32.0	(7.2)
Architecture, Integration, and Management .....	35.1	35.0	(0.1)
Management Reserve .....	4.3	2.3	(2.0)
Subtotal Capital Investments .....	221.9	179.3	(42.6)
Business Systems Modernization Labor .....	44.0	42.0	(2.0)
Subtotal Program Request .....	265.9	221.3	(44.6)
Maintaining Current Levels .....	1.2	1.4	0.2

<sup>3</sup>The Individual Master File is the IRS database that stores individual taxpayer account information.

<sup>4</sup>*Annual Assessment of the Business Systems Modernization Program* (Reference Number 2007–20–121, dated August 24, 2007).

<sup>5</sup>In January 2005, the Government Accountability Office (GAO) combined its two previous high-risk areas, IRS Business Systems Modernization and IRS Financial Management, into one Business Systems Modernization high-risk area. See U.S. Government Accountability Office, GAO–05–207, *High Risk Series: An Update* (2005).

<sup>6</sup>*Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, (GAO 08–567, dated March 2008).



FIGURE 2.—BUSINESS SYSTEMS MODERNIZATION PROJECTS IN FISCAL YEAR 2009 IRS BUDGET REQUEST—Continued  
[In millions of dollars]

Project	Fiscal year 2008 enacted	Fiscal year 2009 budget request	Change from fiscal year 2008 enacted
Total Business Systems Modernization Budget .....	267.1	222.7	(44.4)

Source: TIGTA analysis of GAO Report, Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season (GAO 08-567, dated March 2008).

TIGTA requested information from the IRS on the impact of the proposed funding on the projects above, which the IRS declined to provide. The IRS also declined to provide this information to GAO for its report.

#### *Customer Account Data Engine*

The IRS states that the CADE is the lynchpin modernization project to replace the antiquated master file. The master file currently requires 2 weeks to update taxpayer tax accounts. The CADE consists of current and planned databases and is designed to post information to taxpayers' accounts daily rather than weekly, which will facilitate faster refunds to taxpayers and provide IRS employees with more up-to-date and accurate account information.

The latest release of the CADE, Release 3.0, was originally developed to deliver 17 new functions and capabilities. The IRS divided Release 3.0 into two sub-releases. CADE Release 3.1 contained four major functions and was deployed between August and October 2007. CADE Release 3.2 included seven major functions and was delivered in February 2008. The major functions delivered include the capability of processing tax returns with a disaster area designator; processing tax returns claiming the Earned Income Tax Credit, Credit for Child and Dependent Care, and requests for Split Refunds; providing address change service requests; and validating tax balances. The remaining six functions will be determined for delivery in future releases of the CADE. These additional capabilities were expected to significantly increase the volume of returns posting to the CADE from the approximately 11.2 million returns posted during Calendar Year 2007. As of March 28, 2008, about 21.1 million tax returns had been posted to the CADE.

In 2009, the IRS plans to continue the development of the CADE in stages, and its fiscal year 2009 budget request includes \$58.8 million for the project. TIGTA's review of CADE Release 2.1 found that tax return information was accepted and generally posted accurately to CADE accounts during the 2007 Filing Season.<sup>7</sup> However, several programming problems were affecting the accurate posting of Itemized Deductions, Adjusted Gross Income, and Taxable Income amounts. TIGTA reported this issue to the IRS, and it promptly corrected the programming. TIGTA is currently reviewing the accuracy of the expanded capabilities offered by the most current release of the CADE.<sup>8</sup>

#### *Accounts Management Services Project*

The IRS is continuing to modernize its databases to provide immediate access to account data, enable real-time transaction processing, and ensure daily account settlement to improve customer service and business results. The Accounts Management Services (AMS) project, initiated in May 2006, was chartered to address these needs. The project objective is to provide an integrated approach to view, access, update, and manage taxpayer accounts. This is accomplished by providing IRS employees with the tools to access information quickly and accurately in response to complex customer inquiries and to update taxpayer accounts on demand. The fiscal year 2009 budget request includes \$26.2 million for the AMS project.

In March 2008, TIGTA determined that the AMS project team successfully implemented project management processes and activities, which included project justification, contract management, risk management, configuration management, performance management, and transition management.<sup>9</sup> The AMS project team successfully planned work schedules, identified and addressed potential risks to project development, and coordinated with appropriate staff to implement initial release capabilities. Although the AMS project team is on schedule to make the proposed proc-

<sup>7</sup> *The Customer Account Data Engine Release 2.1 Generally Posted Tax Return Information Accurately* (Reference Number 2007-40-131, dated August 10, 2007).

<sup>8</sup> *Customer Account Data Engine Release 3*, (Audit Number 2008-20-009).

<sup>9</sup> *The Account Management Services Project Is Meeting Its Development Goals* (Reference Number 2008-20-053, dated March 3, 2008).

essing capabilities available, its implementation is dependent on the IRS's Modernization and Information Technology Services organization's abilities to integrate these project capabilities into taxpayer account processing.

The IRS, however, does not collect all transactions and audit logs on its modernized systems, including CADE and AMS. Without audit logs, the IRS cannot conduct proper intrusion investigations and hold individuals accountable for unauthorized transactions and disclosures.

#### *Modernized e-File*

The MeF project provides a standard filing structure for all types of IRS tax returns and can meet performance and capacity needs with enhanced and up-to-date technologies, therefore providing greater appeal to external customers and stakeholders. The MeF project's goal is to replace the IRS's current tax return filing technology with a modernized, Internet-based electronic filing platform.

In fiscal year 2009, the IRS will continue development of Release 7, which was initiated in fiscal year 2008. Release 7 will roll out an additional 90 supporting schedules and forms that will expand the reach of MeF to 99 percent of the e-File population, or approximately 93.7 million filers. The IRS's fiscal year 2009 budget request includes \$25 million for the MeF project.

Previous TIGTA audits of the MeF project found that the IRS's plans for processing additional tax forms using the MeF system were uncertain, including plans to schedule development of the U.S. Individual Income Tax Return (Form 1040) family. In addition, the IRS can improve its management of requirements development and testing activities to assure that the requirements expected and approved for deployment are the requirements that are actually deployed.<sup>10</sup>

Furthermore, TIGTA continues to be concerned that the IRS is developing its modernized systems and bringing them online without adequately contemplating the security implications.

#### *Human Capital*

The IRS, like many organizations, is concerned about an impending retirement wave, or brain drain. According to the IRS, 30 percent of its current employees will be eligible to retire by 2010 and nearly 40 percent of its executives are currently eligible to retire. The GAO has designated human capital as a "high risk" Government-wide concern and recently reported that ample opportunities exist for agencies to improve. TIGTA has also designated the strategic management of human capital as one of the IRS's major management challenges.

Due to the potential loss of institutional knowledge, the IRS has several critical projects underway, such as a 5-year strategic plan for enhancing the services it provides to taxpayers and a complex, multiyear, multibillion dollar effort to modernize its technology and related business processes. The IRS is also battling a tax gap,<sup>11</sup> as well as implementing and adjusting to changes in its managerial and executive pay structure.

It is critical that the IRS effectively implement the human capital strategies listed in the IRS's fiscal year 2009 budget request. While acting to replace those employees lost through retirement and other attrition, the fiscal year 2009 budget request seeks more than 3,000 additional Full-Time Equivalents. The IRS states that additional employees will lead to increased revenue of more than \$2 billion by the time new employees reach their full potential in fiscal year 2011. Not only will the IRS need to place a significant focus on recruiting, it will need to ensure that new employees reach their full potential. At this same time, the IRS will need to retain its more experienced employees and capture the knowledge of those who leave the IRS.

If the IRS is not able to effectively accomplish the human capital strategies:

- There might not be a sufficient number of qualified employees to adequately administer the tax code. In addition, fewer qualified employees may be on the front-line to assist taxpayers.
- The tax gap could increase if high-performing, well-trained taxpayer service and enforcement personnel cannot be hired and retained.
- The IRS might not be able to replace its leadership cadre and ensure that significant projects remain on track.
- The aging workforce could retire before its vast knowledge of tax administration is transferred to younger workers.

<sup>10</sup> *The Modernized e-File Project Can Improve the Management of Expected Capabilities and Associated Costs* (Reference Number 2007-20-005, dated December 27, 2006); *The Modernized e-File Project Can Improve Its Management of Requirements* (Reference No. 2007-20-099, dated July 9, 2007).

<sup>11</sup> The IRS defines the gross tax gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year.

TIGTA has an ongoing Human Capital audit strategy reviewing these areas and will continue to monitor the IRS's efforts to strategically plan and monitor human capital resources to ensure having the right resources in the right place at the right time to achieve its mission and goals.

#### SECURITY OF THE INTERNAL REVENUE SERVICE

Privacy and security are growing concerns in nearly every organization, both private and public. As technology advances, the IRS's ability to protect sensitive information must advance to meet new threats. In addition to the IRS's commitment to protect sensitive taxpayer data and personally identifiable information, a robust security program also requires adequate financial and human capital resources.

Each year, millions of taxpayers entrust the IRS with their sensitive financial and personal data that are stored in and processed by IRS computer systems. The risk that this sensitive data could be compromised and computer operations disrupted continues to increase. Both internal factors, such as the increased connectivity of computer systems and greater use of portable laptop computers, and external factors, such as the volatile threat environment related to increased phishing scams and hacker activity, contribute to these risks.

##### *Network Security*

Because the IRS sends sensitive taxpayer and administrative information across its networks, routers and switches on the networks must have sufficient security controls to deter and detect unauthorized use. In March 2008, TIGTA reported that access controls for IRS routers were not adequate and reviews to monitor security configuration changes were not conducted to identify inappropriate use.<sup>12</sup> Of 374 accounts for employees and contractors to access routers and switches in performing system administration duties, 141 (38 percent) did not have proper authorization to access the routers. Of particular concern, 27 employees and contractors had accessed the routers and switches to change security configurations.

To authenticate users, the IRS relies on a security application that requires users to enter an account name and password. Users circumvented this control by setting up unauthorized accounts that appeared to be shared-user accounts. Any person who knew the password to these accounts could have changed configurations without accountability and with little chance of detection. For this reason, the IRS requires that shared accounts be used only on a limited basis and that they be subjected to special authorization controls. However, during fiscal year 2007, 4.4 million (over 84 percent) of the 5.2 million accesses to the routers were made by the 34 user accounts. Audit trail reviews necessary to detect security events were also not being conducted. The IRS agreed with TIGTA's findings and is taking corrective actions to address the recommendations made to correct these weaknesses.

##### *Database Security*

The IRS stores its taxpayer, financial, and other data in more than 2,100 databases. TIGTA reported in fiscal year 2008 that high-risk weaknesses continue to exist and sufficient corrective actions have not been taken.<sup>13</sup> TIGTA scanned IRS networks and determined that 11 percent of the approximately 1,900 databases scanned had one or more installation accounts with a default or blank password. A total of 369 installation accounts had default or blank passwords, including 26 containing powerful database administrator privileges.

Databases found with default or blank passwords during the scans included those that contained personally identifiable tax information. Malicious users can exploit accounts with default or blank passwords to steal taxpayer identities and carry out fraud schemes.

TIGTA made several recommendations, including ensuring that security training is provided to employees with key security responsibilities and improving the process for identifying and correcting accounts with blank or default passwords by expanding the scanning criteria. IRS management agreed with all of the recommendations in the report and plans to take appropriate corrective actions.

#### IMPROVE TAXPAYER SERVICE

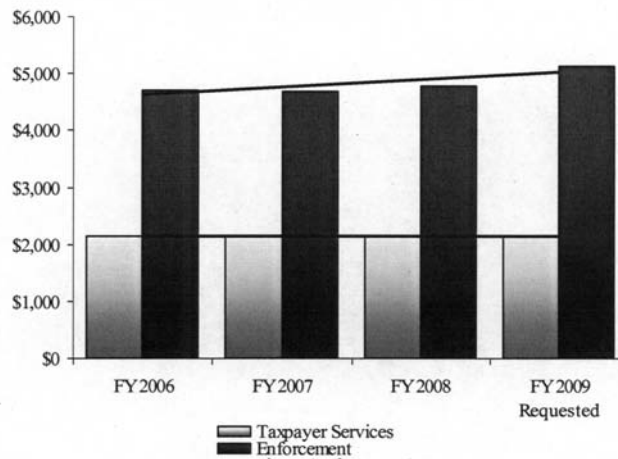
Since the late 1990s, the IRS has increased its delivery of quality customer service to taxpayers. The first goal in the IRS's current strategic plan is to improve taxpayer service. However, since the late 1990s, the IRS has allocated more resources

<sup>12</sup>*Inadequate Security Controls Over Routers and Switches Jeopardize Sensitive Taxpayer Information* (Reference Number 2008-20-071, March 26, 2008).

<sup>13</sup>*Internal Revenue Service Databases Continue to Be Susceptible to Penetration Attacks* (Report Reference Number 2008-20-029, dated December 14, 2007).

to its collection, examination, and criminal investigation functions and fewer resources to taxpayer service functions. See Figure 3 for a comparison of funding for taxpayer service and enforcement since fiscal year 2006.

**Figure 3: Comparison of the Taxpayer Service and Enforcement Appropriations (in millions)**



Source: TIGTA analysis of IRS budgets.

As a result of this resource shift and other factors, in July 2005, Congress requested that the IRS develop a 5-year plan, including an outline of which services the IRS should provide and how it will improve services for taxpayers. The IRS developed the plan, the Taxpayer Assistance Blueprint, in two phases.

The IRS is already facing challenges with its Blueprint. For the Phase I report, the conclusions and strategic improvement themes were valid; however, not all information was accurate or consistent.<sup>14</sup> Given the importance of this plan as the IRS moves forward, inaccuracies and inconsistencies will put the plan at risk of improperly aligning service content, delivery, and resources with taxpayer and partner expectations. In fiscal year 2007, the IRS issued its Taxpayer Assistance Blueprint Phase 2 report that details the research and analyses efforts of the IRS and outlines the Blueprint Strategic Plan for taxpayer services. The Phase 2 report contains information from over 100 data sources and represents the first large-scale effort to attempt to collect data specific to Taxpayer Assistance Center customers. In February 2008, TIGTA reported that the data in the Phase 2 report was for the most part accurate.<sup>15</sup>

A second review of the Phase 2 report focused on the Taxpayer Assistance Center<sup>16</sup> Geographic Footprint—the IRS’s step-by-step process for future decisions regarding Taxpayer Assistance Center locations—and found that inaccurate and incomplete management information continues to delay its implementation.<sup>17</sup> The IRS has yet to determine the optimum locations for the Taxpayer Assistance Centers and which taxpayers they most effectively serve. Additionally, of the 41 criteria used

<sup>14</sup> *The Strategic Improvement Themes in the Taxpayer Assistance Blueprint Phase I Report Appear to Be Sound; However, There Were Some Inaccurate Data in the Report* (Reference Number 2007-40-078, dated March 18, 2007).

<sup>15</sup> *The Taxpayer Assistance Blueprint Phase 2 Was Generally Reliable, but Oversight of the Survey Design Needs Improvement* (Reference Number 2008-40-059, dated February 5, 2008).

<sup>16</sup> Taxpayer Assistance Centers are walk-in sites where taxpayers can receive answers to account and tax law questions, as well as assistance in preparing their tax returns.

<sup>17</sup> *Inaccurate and Incomplete Data Has Adversely Affected the Implementation of the Taxpayer Assistance Center Geographic Footprint* (Audit # 200740042), Draft issued March 20, 2008.

for the Taxpayer Assistance Center Geographic Blueprint, 19 (46 percent) contained inaccurate or incomplete data. Without accurate and complete data, the IRS cannot measure the effectiveness of the Taxpayer Assistance Center Program or determine where to best offer its face-to-face services.

The IRS is also still unable to measure how closing Taxpayer Assistance Centers might affect taxpayers and compliance. The IRS does not have the means to capture all interactions between a Taxpayer Assistance Center employee and a taxpayer to determine why the taxpayer visited the Taxpayer Assistance Center, what service he or she received, and, most importantly, the effect the service or action had on the taxpayer's future compliance.

The President's fiscal year 2009 budget request for the Taxpayer Service Program is \$2.15 billion. The fiscal year 2009 funding for the direct appropriation maintains the fiscal year 2008 enacted level. The Operations Support budget provides an additional \$1.5 billion to support taxpayer services.

- Fiscal year 2009 program decreases include funds provided in the fiscal year 2008 enacted. Specifically, \$31 million is being used for long-term investments that would not be duplicated in 2009, and \$8 million from the Community Volunteer Income Tax Assistance (VITA) Matching Grant Program that was provided in fiscal year 2008 and is still available through fiscal year 2009.

- Fiscal year 2009 increases include an additional 426 Full-Time Equivalents and \$14.8 million to fully fund postal costs.

The budget request does not include funding to support any taxpayer service initiatives that increase its 2009 request over the 2008 enacted amount. The IRS has expended considerable resources to develop the Blueprint and many of its initiatives would provide its customers with the same services currently available to them from private financial organizations. Most of the Blueprint initiatives have not been funded. The IRS must continue to find out what assistance taxpayers want and need, and ensure that the Blueprint Strategy Plan is effectively implemented.

The IRS is implementing a new matching grant program for the Community VITA Grant Program with \$8 million in fiscal year 2008 funding. The IRS's Volunteer Program, including the VITA and the Tax Counseling for the Elderly Programs,<sup>18</sup> plays an increasingly important role in the IRS's efforts to improve taxpayer service and facilitate participation in the tax system. TIGTA recently reviewed the Tax Counseling for the Elderly Program and found that it has not been effectively administered. The IRS does not have effective controls or monitoring processes to ensure that funds are appropriately spent, and management information is not sufficient to provide adequate oversight for the program. The IRS is using TIGTA's audit results to develop the VITA grant program.<sup>19</sup>

#### ENHANCE ENFORCEMENT OF TAX LAWS

A compelling challenge confronting the IRS is tax compliance. Tax compliance initiatives include the administration of tax regulations, collection of the correct amount of tax for businesses and individuals, and oversight of tax-exempt and Government entities. Late in fiscal year 2007, the Department of the Treasury and the IRS issued a report on improving voluntary compliance.<sup>20</sup> The report outlines steps that the IRS plans to take to increase voluntary compliance and reduce the tax gap.

The fiscal year 2009 IRS budget request seeks nearly \$361 million in program increases for IRS enforcement initiatives, which account for 77 percent of the agency's overall funding increase of \$469 million. Part of the enforcement initiative funding is intended to hire 3,057 new IRS Enforcement and Operations Support employees who are expected to help generate over \$2 billion<sup>21</sup> in additional annual enforcement revenue, once the new hires reach full potential in fiscal year 2011. The \$361 million increase is split between three appropriation accounts: Enforcement (\$261 million), Operations Support (\$97 million), and Taxpayer Services (nearly \$3 million). Many of the same or similar enforcement proposals described in the fiscal year 2009 budget request were included in the fiscal year 2008 IRS budget request but not funded by Congress in the final appropriations bill, the Consolidated Appropria-

<sup>18</sup>The Tax Counseling for the Elderly Program is a grant program that provides free tax help to people age 60 and older using grants appropriated. The Tax Counseling for the Elderly Program appropriation was \$3.95 million for each of fiscal years 2005 through 2007 and \$3 million in fiscal year 2008.

<sup>19</sup>*Oversight and Administration of the Tax Counseling for the Elderly Program Need Improvement.*

<sup>20</sup>Internal Revenue Service, U.S. Department of the Treasury, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (2007).

<sup>21</sup>Amount does not include annual \$3.6 billion expected from legislative proposals.

tion Act of 2008.<sup>22</sup> The programs included in the enforcement initiatives in the fiscal year 2009 IRS budget request are shown in Figure 4:

FIGURE 4.—ENFORCEMENT INITIATIVE PROGRAMS IN FISCAL YEAR 2009 IRS BUDGET REQUEST  
[Dollars in millions]

Program	Cost	Expected revenue fiscal year 2011	Staffing increase (full-time equivalents)	Included in fiscal year 2008 IRS budget request
Reduce the tax gap for small business/self-employed taxpayers.	\$168.5	\$981	1,608	Yes
Reduce the tax gap for large businesses .....	69.5	544	519	Yes
Improve tax gap estimates, measurement and detection of non-compliance.	51.1	16	393	Yes
Increase reporting compliance of U.S. taxpayers with offshore activity.	13.7	102	124	No
Expand document matching .....	35.1	359	413	Yes
Implement legislative proposals to improve compliance.	23.0	3,600	.....	Yes
Totals .....	360.9	5,602	3,057	

Source: TIGTA analysis of fiscal year 2008 and fiscal year 2009 IRS Budget Requests.

#### ADDRESSING THE TAX GAP

Tax compliance initiatives include administering tax regulations, collecting the correct amount of tax for businesses and individuals, and overseeing tax-exempt and Government entities for compliance. Increasing voluntary compliance and reducing the tax gap are currently the focus of many IRS initiatives. Nevertheless, the IRS is facing significant challenges in obtaining more complete and timely data, and developing the methods necessary for interpreting the data. The IRS must continue to seek accurate measures for the various components of the tax gap and the effectiveness of the actions taken to reduce it. Broader strategies and better research are needed to determine what actions are most effective in addressing non-compliance.

##### *Unreported Self-Employment Taxes Contribute to the Tax Gap*

According to the GAO, outlays from the main trust funds of the Social Security and Medicare programs are projected to exceed revenues in the next decade. As the tax collector for these programs, the IRS must ensure that self-employed taxpayers meet their tax responsibilities by assessing and collecting the proper amount of self-employment taxes. Self-employment tax is estimated to make up about \$39 billion (72 percent) of underreported employment taxes, or 11 percent of the total gross tax gap, making it one of the largest components of the tax gap.

TIGTA's fiscal year 2007 review of the self-employment tax found that IRS procedures were inconsistent for identifying Form 1040 reporting income on line 21 that is potentially subject to the self-employment tax.<sup>23</sup> Also, there was a significant problem with assigning an audit code to tax returns with potentially unreported self-employment taxes.

TIGTA recommended that the IRS: (1) improve processing of those tax returns with potential self-employment tax liabilities and provide additional training to tax examiners; (2) strengthen reviews of tax returns for potential unpaid self-employment taxes; and (3) reconsider the decision to cancel TIGTA's previous recommendation to immediately work significant unreported self-employment tax cases with refunds available and no response or an inadequate response to any letter issued by the IRS.

IRS management agreed with the first two recommendations and disagreed with the third. The IRS planned to explore the possibility of expanding existing returns processing training material issued in January 2008. However, IRS management stated that the parameters could not be accurately identified to ensure that the IRS would not be withholding the refunds of taxpayers who were not subject to self-employment taxes. Based on the findings of this and previous audits, TIGTA maintained that it was feasible for the IRS to begin examining the tax returns of tax-

<sup>22</sup> Consolidated Appropriation Act of 2008, Public Law 110–161.

<sup>23</sup> Identification of Unreported Self-Employment Taxes Can Be Improved (Reference Number 2008–30–001, dated October 11, 2007).

payors who appear to owe a significant amount of self-employment tax, have an available refund, and have not responded to contact letters from the IRS.

*Schedule C Hobby Losses Contribute to the Tax Gap*

About 1.5 million taxpayers, many with significant income from other sources, filed Form 1040 Schedules C (Profit or Loss From Business) showing no profits, only losses, over four Tax Years 2002–2005; 73 percent were assisted by tax practitioners. By claiming these losses to reduce their taxable incomes, about 1.2 million of the 1.5 million taxpayers potentially avoided paying \$2.8 billion in taxes in Tax Year 2005. Changes are needed to prevent taxpayers from continually deducting losses in potential not-for-profit activities to reduce their tax liabilities.

The “hobby loss” provision and related regulations do not establish specific criteria for the IRS to use in determining whether a Schedule C loss is a legitimate business expense without conducting a full examination of an individual’s books and records.<sup>24</sup> The purpose of the hobby loss provision was to limit the ability of wealthy individuals with multiple sources of income to apply losses incurred in “side-line” diversions to reduce their overall tax liabilities. TIGTA reported in September 2007 that 332,615 high-income taxpayers received the greatest benefit by potentially avoiding approximately \$1.9 billion in taxes for tax year 2005.<sup>25</sup>

The law does not require a taxpayer to have a reasonable expectation of profit; rather, the taxpayer needs only the “objective” of making a profit. Internal Revenue Code (I.R.C.) §183 makes it difficult for the IRS to efficiently administer tax law that ensures taxpayers are not deducting not-for-profit losses to reduce their taxes on other incomes year after year.

TIGTA recommended that the IRS provide a copy of the report to the Department of the Treasury, Office of Tax Policy, to consider legislative changes to I.R.C. § 183. The proposal should include establishing a clearly defined standard or bright-line rule for determining whether an activity is a business or a not-for-profit activity. Due to the large number of these tax returns being prepared by tax practitioners, TIGTA also recommended that the IRS continue coordinating with practitioner organizations to encourage compliance with existing provisions.

In their response to the report, IRS officials stated that they agreed with the recommendations and planned to take appropriate corrective actions. The IRS plans to coordinate with the Office of Legislative Affairs to forward a copy of the final report to the Department of the Treasury, Office of Tax Policy, and to include key messages and talking points about I.R.C. §183 tax obligations as a fiscal year 2008 outreach initiative directed to practitioner organizations.

#### LEGISLATIVE PROPOSALS

The fiscal year 2009 IRS budget request includes 16 legislative proposals—13 submitted in prior budget requests—that are expected to generate \$36 billion in additional tax over 10 years as a result of improving tax compliance and administration. Of the 13 proposals in prior budget requests, 12 await some form of congressional action. Many of these proposals also represent a significant part of the IRS strategy to improve tax compliance and reduce the tax gap described in the IRS’s August 2, 2007, report, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*.

#### 2008 FILING SEASON

The 2008 Filing Season appears to be progressing without major problems. As of March 29, 2008, the IRS reported that it had received approximately 86.8 million tax returns. Of those, approximately 62.2 million were filed electronically (e-filed) (an increase of 9.3 percent from this time in 2007), and approximately 24.6 million were filed on paper (an increase of 4.8 percent from this time in 2007). Additionally, nearly 69.8 million refunds totaling approximately \$172 billion had been issued. Of these, 50.8 million (73 percent of all refunds) were directly deposited to taxpayer bank accounts, an increase of 7.3 percent compared to 2007.

Use of the IRS’s free online filing program had been declining in prior years. However, based on the current volume, it appears that taxpayers are increasingly taking advantage of this option, as the number has increased by 17.4 percent from 2007. Additionally, the number of taxpayers who e-file from their home computers increased by 17.3 percent this filing season.

<sup>24</sup> Internal Revenue Code Section 183 (Activities not engaged in for profit); related Treasury Regulation Section 1.183–1.

<sup>25</sup> *Significant Challenges Exist in Determining Whether Taxpayers With Schedule C Losses Are Engaged in Tax Abuse (Reference Number 2007–30–173, dated September 7, 2007)*.

So far this filing season, over 2 million tax returns have been prepared by volunteers, an increase of 22 percent over the 2007 Filing Season. TIGTA's accuracy rate at the Volunteer Program sites has improved from 56 percent last year to 67 percent this year. The IRS is reporting a 76 percent accuracy rate. Volunteers are doing a better job using the tools and information available when preparing tax returns.

As of March 29, 2008, use of IRS.gov is up over 19 percent, with almost 122 million visits to the Web site. Nearly 26 million taxpayers went to IRS.gov to obtain their refund information via the "Where's My Refund?" option, a 19.7 percent increase over the same time period last year.

Additionally, calls to the toll-free assistance lines are up from the 2007 Filing Season and the Level of Service<sup>26</sup> is lower, primarily because taxpayers are calling about the stimulus payments. The IRS had planned to provide an 82 percent Level of Service for fiscal year 2008, but has projected that the Level of Service could be as low as 74 percent. For the 2008 Filing Season (as of March 29, 2008), the IRS had already answered about 112 percent of the planned 10.9 million assistor-answered calls. Its 80 percent Level of Service is 4.5 points lower than the actual 2007 Filing Season Level of Service of 84.5 percent. Additionally, the IRS had planned to answer 14.8 million automated calls but has answered 16.1 million automated calls.

#### ECONOMIC STIMULUS ACT OF 2008<sup>27</sup>

In keeping with the intent of the Economic Stimulus Act of 2008, the IRS expects to issue more than \$100 billion in stimulus payments (often referred to as rebates) and is trying to ensure that everyone who is entitled to a rebate knows what to do to receive it. The IRS sent Economic Stimulus Payment Notices (Notice 1377) to more than 130 million taxpayers who filed a Tax Year 2006 income tax return. Beginning in May, an additional notice will be mailed to those taxpayers eligible for the payments to explain the payment amount and how it was calculated. The IRS believes it will receive significantly fewer calls to its toll-free telephone information line as a result of issuing the advance notices.

As of March 28, 2008, the IRS had received an estimated 1.4 million tax returns from individuals who filed them solely to receive the rebates. Because these are tax returns that would generally not be filed, the normal IRS refund controls are not designed for this situation. The IRS is evaluating alternatives to identify any of these tax returns that are fraudulent so it can prevent any associated fraudulent stimulus payments. TIGTA is currently evaluating the controls over the processing of these tax returns and monitoring their volume and effect on the 2008 filing season.

Since the Economic Stimulus Act of 2008 was enacted, the IRS has been receiving an average of more than 63,000 calls per day above normal volume to its toll-free telephone lines related to the upcoming rebates. The IRS is using over 1,000 Automated Collection System<sup>28</sup> telephone assistants to take rebate telephone calls during their regular tours of duty and has also trained more than 500 tax examiners and assistants who normally work taxpayer correspondence and paper casework to answer general rebate calls.

The IRS stopped the issuance of Automated Collection System enforcement tools (systemic notices and letters were stopped on February 22 and systemic levies were stopped on February 29). However, issuance of regular delinquency notices on accounts not yet assigned to the Automated Collection System has not been stopped, and the IRS expects to reserve 40 percent to 50 percent of the available Automated Collection System staff to answer calls from taxpayers who respond to these notices. The IRS plans to restart the notices when telephone demand decreases. The IRS reports that the foregone revenue associated with these actions could be as high as \$666 million.

<sup>26</sup>The Level of Service is the primary measure of service to taxpayers. It is the relative success rate of taxpayers who call for services on the IRS toll-free telephone lines.

<sup>27</sup>Economic Stimulus Act of 2008, Pub. L. No. 110-185 (2008).

<sup>28</sup>The Automated Collection System is an integral part of the IRS process for collecting unpaid taxes and securing unfiled tax returns from both individual and business taxpayers. When taxpayers do not comply with the IRS's computer-generated notices, Automated Collection System tax examiners attempt to contact them by telephone to secure payments or unfiled returns. The Automated Collection System is the computer system that assigns these cases to the individual tax examiners.



## TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION FISCAL YEAR 2009 BUDGET REQUEST

TIGTA was created by Congress to provide independent oversight of the IRS. TIGTA's audits and investigations protect and promote the fair administration of the Nation's tax system. Responsibilities include ensuring that the IRS is accountable for more than \$2 trillion in tax revenue received each year. Audit recommendations aim to improve IRS's systems and operations while maintaining fair and equitable treatment of taxpayers. Investigations are focused on IRS employee misconduct and infrastructure security, as well as external attempts to corrupt Federal tax administration.

TIGTA's Office of Audit (OA) conducts audits that advise Congress, the Secretary of the Treasury, and IRS management of high-risk issues, problems, and deficiencies related to the administration of IRS programs and operations. Audits not only focus on the economy and efficiency of IRS functions but also ensure that taxpayers' rights are protected and the taxpaying public is adequately served. Overall, as of March 31, 2008, audit reports potentially produced financial accomplishments of \$172.5 million, and potentially impacted approximately 1,217,000 taxpayer accounts in areas such as taxpayer burden, rights, and entitlements. OA develops an annual audit plan that communicates oversight priorities to Congress, the Department of the Treasury, and the IRS. Emphasis is placed on mandatory coverage imposed by the IRS Restructuring and Reform Act of 1998<sup>29</sup> and other statutory authorities, as well as issues impacting computer security, taxpayer rights and privacy, and financial-related audits. OA's work focuses on the IRS's major management challenges, the progress in achieving its strategic goals, the elimination of the IRS's systemic weaknesses, and the IRS's response to the President's Management Agenda initiatives.

TIGTA's Office of Investigations (OI) conducts investigations that protect the integrity of IRS employees, contractors, and other tax professionals; provides for infrastructure security; and protects from external attempts to threaten or corrupt the administration of Federal tax laws.

TIGTA's OI investigates employee misconduct involving unauthorized access (UNAX) of confidential taxpayer records, theft, false statements, financial fraud, taxpayer abuses, and extortion.

OI assists in maintaining IRS employee and infrastructure security by investigating incidents of threats or assaults made against IRS employees, facilities, and data infrastructure. As mentioned previously, the IRS's fiscal year 2009 budget request seeks a 7.1 percent increase in its enforcement appropriation. This continued focus on enforcement has resulted in OI receiving higher levels of reported assaults and threats against IRS personnel. Additionally, the IRS's increasing reliance on electronic processes has resulted in an increased need for OI to investigate and respond to cyber attacks.

TIGTA also investigates allegations involving external attempts to corrupt tax administration, such as bribes offered by taxpayers to compromise IRS employees, the use of fraudulent IRS documentation to commit crimes, taxpayer abuse and misconduct by tax practitioners, impersonation of IRS employees, and the corruption of IRS programs through procurement fraud.

TIGTA faces major human capital challenges in delivering and adapting its oversight activities to the increasingly complex and high-risk issues associated with IRS operations. Some of these issues include detection and investigation of fraud and electronic crime, procurement activities, taxpayer privacy, and an increasing number of requests for IRS program reviews from Congress and other IRS stakeholders. While adapting to this changing environment, approximately 37 percent of TIGTA employees are eligible for retirement by fiscal year 2011.

Additionally, in order to accomplish its mission, TIGTA employees need to possess the appropriate skills. As the IRS continues to modernize and operate in an automated environment, it is essential that TIGTA auditors and investigators are appropriately trained to operate in this environment.

To help address these challenges, TIGTA has initiated or is initiating the following actions in fiscal year 2008:

- Created the Office of Inspections and Evaluations whose mission is to provide TIGTA with additional flexibility, capacity and capability to provide value-added products and services to improve tax administration and promote good

<sup>29</sup> Pub. L. No. 105–206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

Government. This function was created and staffed by a realignment of existing resources.

- Implementing a bureau-wide electronic learning management system containing a skills assessment program that identifies the critical skills needed for each of TIGTA's major occupations and provides a means to assess resident skill levels. Based on the results, TIGTA will develop a strategic recruitment program to fill critical vacancies with the skills necessary to carry out its increasingly complex oversight activities and align future hiring in critical geographic areas.
- Building its first Senior Executive Service Candidate Development Program. The objective of the program is to promote a greater understanding of the mission and culture of the Federal Government and to train outstanding leaders and prepare them for the Senior Executive Service.

Mr. Chairman, as you requested, I will discuss TIGTA's 2009 budget needs. From fiscal year 2001 to fiscal year 2007, TIGTA's labor expenses have grown 20 percent from \$88 million to \$106.3 million, despite a substantial reduction in Full-Time Equivalents (a decrease of 16 percent from 938 to 792). Labor costs currently account for 80 percent of TIGTA's annual budget. As the number of TIGTA employees covered under the more expensive Federal Employees Retirement System increases, labor costs will continue to rise, reducing the funds available to TIGTA for non-labor spending.

Since fiscal year 2001, TIGTA has only been able to meet its financial obligations through Full-Time Equivalent losses and implementation of cost-cutting initiatives in non-labor expense categories. From fiscal year 2001 to fiscal year 2007, non-labor spending (such as training, travel, equipment, etc.) fell 9 percent from \$19.5 million to \$17.7 million. These costs currently consume 13 percent of TIGTA's annual budget.

The fiscal year 2009 President's budget request for TIGTA will be used to continue to provide critical audit and investigative services, ensuring the integrity of tax administration on behalf of the Nation's taxpayers. While there are a number of critical areas in which TIGTA will provide oversight, highlights of TIGTA's investigative and audit priorities include:

- Adapting to the IRS's continually evolving operations and mitigating intensified risks associated with modernization;
- Addressing the tax gap and enforcement efforts;
- Responding to threats and attacks against IRS employees, property, and sensitive information;
- Improving the integrity of IRS operations by detecting and deterring fraud, waste, abuse or misconduct by IRS employees;
- Conducting comprehensive audits, inspections, and evaluations that include recommendations for cost savings and enhancing the IRS's service to taxpayers; and
- Informing Congress and the Secretary of the Treasury of problems and progress made to resolve identified issues.

The total resources needed in fiscal year 2009 to support TIGTA's mission are \$146,636,000, including \$145,736,000 from direct appropriations and approximately \$900,000 from reimbursable agreements. This is a \$5.2 million (3.7 percent) increase over the fiscal year 2008 spending authority compared with the IRS's 4.3 percent increase.

I hope my discussion of the continuing challenges that face the IRS and TIGTA will assist you as you consider the fiscal year 2009 budget. Mr. Chairman and Members of the subcommittee, thank you for the opportunity to share my views.

Senator DURBIN. You should have filed for an extension 1 minute and 6 seconds ago.

Willie Nelson will be your hearing officer.

On behalf of the IRS Oversight Board, Paul Cherecwich.

**STATEMENT OF PAUL CHERECWICH, JR., CHAIRMAN, INTERNAL REVENUE SERVICE OVERSIGHT BOARD**

Mr. CHERECWICH. Chairman Durbin, Ranking Member Brownback, and members of the subcommittee staff who are here, thank you very much. My name is Paul Cherecwich. I am chair of the IRS Oversight Board.

One of our most important responsibilities is to ensure the IRS budget and related performance expectations support the IRS stra-

tegic plans. I would like to take this time to summarize the Board's recommendations for the IRS fiscal year 2009 budget.

If I had one word to characterize the difference between the Board's recommendations and the President's request, it would be "direction." I have taken the liberty of making a chart of one of the key figures in my written statement because I think that best illustrates the difference in the direction the Board is recommending.

This chart shows the four major line items in the IRS budget. The Board wants to spend more for service and information technology (IT) modernization. The President would spend less. It would appear that the Board and the President have similar recommendations for enforcement, but when you get inside the numbers, there are real differences in balance. And the Board would spend about \$100 million more for infrastructure, but the President's budget would keep the infrastructure budget at its present underfunded state.

Let us start at the top with funding for taxpayer service. To put it simply, the Board wants the IRS to do more service, not less, especially service that helps taxpayers better understand their obligations and service targeted at underserved taxpayers. Most of the additional money for service that Congress added to the IRS budget last year would be eliminated by the President's budget. The Board believes the taxpayer assistance blueprint needs to be funded, and I have personally visited volunteers in tax assistance (VITA) sites in Utah, Georgia, and Kansas and can tell you that VITA is delivering important services to underserved taxpayers.

With respect to enforcement, it may seem that the Board and the President are making identical recommendations, for the funding is so close, about \$360 million. And reality is my written statement shows the Board's recommended enforcement programs are spread more broadly and not focused exclusively in a few areas. As discussed in my statement, the Board has also questioned the ability of the IRS to absorb the requested staffing in its small business, self-employed, and large business divisions.

With respect to infrastructure, that is something that tends to be forgotten, but it is really quite important. The Board believes more funding for security is important in an age where the IRS is under increasing pressure to protect its databases from assault and keep taxpayer records private. I note that just the last week my colleague, Mr. George, issued a report chastising the IRS for their lack of security. The IRS does put a high priority on maintaining taxpayer privacy, but more should be done.

People are also an important part of the IRS infrastructure and more attention must be paid to having an aging workforce effectively pass along their skills and special expertise to the next wave of leaders and employees.

Now, the biggest difference in dollars between the Board and the President's budget is in business systems modernization (BSM). We have a \$185 million difference between the Board's recommendation and the President's recommendation. By the way, this is the appropriations line. Technology modernization will result in major benefits to taxpayers and the Government. The Board believes the BSM to be the highest priority because of its ability to contribute to reducing the tax gap in the long term. We simply have to make

progress faster. TIGTA and GAO have recently been reporting positively on the business systems modernization program. This is not the time to go backward in funding.

Among other things, erratic funding makes program management more difficult and creates staffing issues for both the IRS and the contractors. When projects are cut back, you always lose the talented people you most want to keep.

Few taxpayers would use a financial institution that updated its accounts weekly. Yet, we accept that for the IRS. This has to change.

Modernized systems are required for electronic filing and financial controls. The failure of funding to upgrade the integrated financial system is going to prevent the IRS from managing its own accounts better.

Now that I have summarized the Board's recommendations on the four major accounts, let me make a point on the entire IRS budget. There is a television program on the Discovery channel called "Myth Busters" whose avowed mission is to separate truth from fiction, and I want to bust a myth about the IRS. The myth is that taxpayers who are also voters will be unhappy if too much money is appropriated for the IRS. The Board has tested that myth in our taxpayer attitude surveys and found it was wrong. My written statement provides the details.

#### PREPARED STATEMENT

In conclusion, the Congress must choose whether it wants to pursue short-term growth in enforcement activity over a more balanced path that stresses the benefits of long-term investments in technology infrastructure, service, and research.

Thank you for the opportunity to present the board's views.

Senator DURBIN. Thanks.

[The statement follows:]

#### PREPARED STATEMENT OF PAUL CHERECWICH, JR.

Chairman Durbin, Ranking Member Brownback, and members of the Subcommittee, thank you for this opportunity to present the Oversight Board's views on the administration's fiscal year 2009 IRS budget request. My name is Paul Cherecwich and I serve as Chairman of the IRS Oversight Board. My testimony explains the Board's recommendations for the IRS fiscal year 2009 budget and why the Board believes this level of funding is needed to meet the needs of the country and of taxpayers.

Created as part of the IRS Restructuring and Reform Act of 1998 (RRA 98), the Oversight Board's responsibilities include overseeing the IRS in its administration, management, conduct, direction and supervision of the execution and application of the internal revenue laws. The Board is also responsible for ensuring that the IRS' organization and operations allow the agency to carry out its mission. To this end, the Board was given specific responsibilities for reviewing and approving annual budgets and strategic plans.

In fulfilling its responsibilities, the Board must ensure that the IRS' budget and the related performance expectations contained in the performance budget support the annual and long range plans of the IRS, support the IRS mission, are consistent with the IRS goals, objectives and strategies and ensure the proper alignment of IRS strategies and plans. In addition to my statement today, the Board developed a formal report in which it explains why it has recommended this budget for the IRS. I request that my statement and the report be entered into the committee record.

## FISCAL YEAR 2009 IRS BUDGET RECOMMENDATIONS

One of the IRS Oversight Board's most important statutory responsibilities is to ensure that the IRS' budget request supports the agency's annual and long-term strategic plans. A budget request is more than a mechanism for appropriating funding; it's also a plan and a commitment. Not only does a proposed budget request funding, it also describes the activities the IRS will perform, how those activities align with the long-range strategic plan, and identifies measures to evaluate the expected results. A performance budget, properly used, enhances the ability of the IRS to meet its short-term performance targets and three strategic plan goals: (1) improve customer service; (2) enhance enforcement of the tax law; and (3) modernize the IRS through its people, processes and technology.

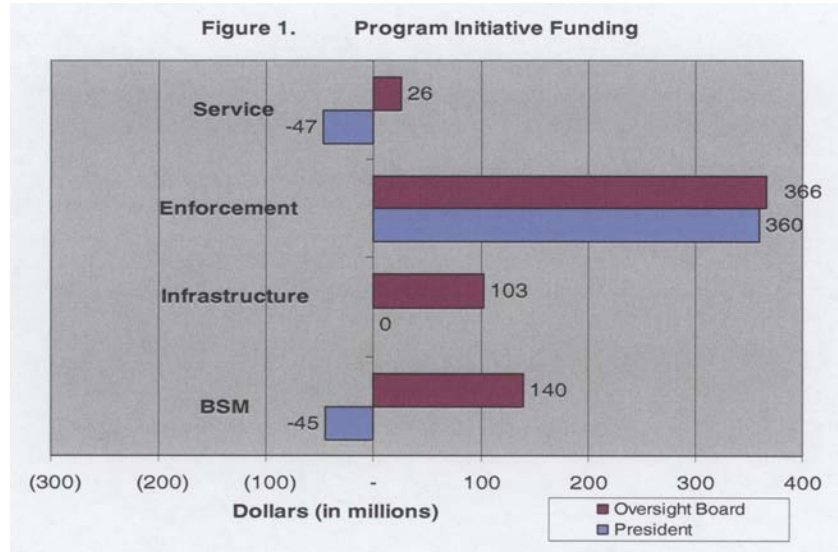
Achieving these three strategic goals will enable the IRS to address the most serious problem facing tax administration today—reducing the tax gap, the difference between what taxpayers should be paying and what they actually pay in a timely manner. The size of the tax gap is significant, with the IRS' most recent estimates placing it at approximately \$290 billion (net) annually, based on 2001 tax returns. The imperative for closing the tax gap has never been greater. An annual net tax gap of \$290 billion averages to about \$2,200 per individual tax return, an enormous burden for the average taxpayer, and one that should not be tolerated by honest taxpayers. It is far too large to be dismissed lightly—it imposes a large burden on all taxpayers and undermines respect for tax administration.

The IRS Oversight Board recommends an IRS fiscal year 2009 budget of \$11.737 billion, an increase of \$845 million over the enacted fiscal year 2008 amount of \$10.892 billion, as summarized in Tables A-1 and A-2 in Appendix A.

The recommended budget takes a long-term view of IRS needs. Despite the severity of the tax gap, the Board believes such a view is both warranted and needed. In submitting its fiscal year 2009 budget recommendations to the Treasury Department in June 2007, the Board identified increased funding for Business Systems Modernization (BSM), security, infrastructure, and research as high priorities. These initiatives offer the best opportunity to reduce the tax gap in the long term.

By following this approach, the Board's recommended budget maintains balance at its core: enforcement, taxpayer service, business systems modernization, and employee development must be adequately funded for the IRS to succeed in all parts of its mission and to ensure the long-term health of our tax administration system.

The Board's recommended IRS budget compares to the President's request of \$11.361 billion, an increase of \$469 million over the fiscal year 2008 enacted appropriation. Although the two budgets are within 3.3 percent, they take different approaches to funding priority program initiatives at the margin. The Board recommends a total of \$644 million in program initiatives, spread among four areas: enforcement, taxpayer service, infrastructure and IT, and BSM. The President's budget requests a nearly identical amount of funding for enforcement initiatives as the Board, but cuts taxpayer service and BSM funds, and includes no program initiatives for infrastructure and IT. Figure 1 shows the differences in graphic form.



Although both budgets have as a core objective the reduction of the tax gap, the Board recommends funding initiatives across the full range of IRS functions and taxpayer segments. In contrast, the President's budget has as its central focus a short-term effort to build up IRS revenue-producing enforcement staffing at a time when the IRS is hard-pressed to replace the high number of experienced employees who are retiring. Increased staffing is important, but the Oversight Board believes the IRS cannot "audit its way out of the tax gap," and should avoid the temptation to close the tax gap with large staffing increases in revenue-producing functions that cannot be absorbed effectively. The Board believes its recommended budget avoids this problem by focusing on ways to make the IRS more efficient in the long term, and putting more resources into technology, infrastructure, and service as well as enforcement.

Because reducing the tax gap is of critical importance, the Board has identified a subset of its recommended initiatives as having the highest priority. These initiatives are generally infrastructure and research intensive and will have the greatest effect on reducing the tax gap in the long term, and are identified in Table 1.

**TABLE 1.—IRS OVERSIGHT BOARD HIGHEST PRIORITY INITIATIVES**  
[Dollars in millions]

	Amount
<b>Technology/Infrastructure:</b>	
Fund Business Systems Modernization in Line with Current Strategy .....	\$141.0
Enhance IT Security .....	\$16.7
Enhance Contingency Planning and Disaster Recovery .....	\$8.7
Implement Security Auditing .....	\$6.8
Preserve quality IT workforce in applications development .....	\$36.8
Build alternate power supply for computing center .....	\$11.0
Subtotal, Technology/Infrastructure .....	\$221.2
Enforcement: Improve tax gap estimates, measurement, and detection of non-compliance .....	\$11.1
Taxpayer Service: Research Taxpayer Burden, Complexity, and Compliance .....	\$10.0
Total Highest Priority Initiatives .....	\$2.3

None of these initiatives, except the enforcement initiative for improving tax gap estimates, are funded in the President's budget. Moreover, as shown in Figure 1, the BSM program and taxpayer service programs undergo reductions of \$45 million

and \$47 million, respectively. The Board recommends that the appropriated IRS fiscal year 2009 budget closely follow the priorities and balance reflected in this statement.

The following sections discuss the Board's budget recommendations in the context of each of the IRS' strategic goals.

*Strategic Goal 1—Improve Taxpayer Service*

IRS customer service has made consistent gains since fiscal year 2002. For example, Toll-Free Tax Law Accuracy and Accounts Accuracy are at 91 percent and 93 percent respectively in fiscal year 2007, as compared to 84.4 percent and 90 percent 5 years ago. Of particular note, overall customer satisfaction with IRS Toll-Free Service has held steady at 94 percent for four consecutive years. Such stability is most welcome and a good indicator that best practices have taken root.

As a result, a more pressing challenge is to deliver more extensive electronic self-assistance tools and to perform research that identifies innovative ways to expand taxpayer education and outreach to all taxpayer segments, especially those who are now under served.

To a large degree, many of the IRS' customer service activities are designed to respond to taxpayer inquiries. Examples include toll-free telephone service and Taxpayer Assistance Centers. Overall, the IRS has done a good job fielding and answering questions, whether via toll-free telephone, the Internet, or in person at Taxpayer Assistance Centers.

The IRS expends considerably fewer resources on education and outreach services. A broader approach to customer service would entail giving taxpayers access to self-service applications so they could "pull" specific information on accounts or tax law, and "pushing" answers, information and updates to taxpayers, practitioners and other affected parties as the need for such information became apparent. Lastly, the IRS must seize opportunities to provide innovative outreach, education and community partnerships. For example, given limited resources and elimination of programs such as TeleFile, the IRS must also work to broaden and strengthen partnerships, such as Volunteers in Tax Assistance (VITA).

To take service to the next level, the IRS must better understand the taxpayers they serve. The IRS must conduct more insightful research, and develop services better tailored to the specific needs of particular taxpayer segments. By better understanding taxpayers, the IRS can focus both its service and enforcement efforts to increase compliance through targeted pre-filing, filing, and post-filing efforts. The IRS must find out what kind of information and assistance taxpayers need and the most effective ways of delivering that information to them.

In the last 2 years, the IRS has put considerable effort into developing the Taxpayer Assistance Blueprint (TAB), which establishes a 5-year plan for delivering service to taxpayers. This vision entails a much broader use of electronic interactions between taxpayers, practitioners and the IRS, such as account management and the ability to resolve taxpayer issues securely over the Internet. The TAB describes an IRS that is an "interactive and fully integrated, online tax administration Agency" with the capability "for any exchange or transaction that occurs face-to-face, over the phone, or in writing to be completed electronically." These types of services are much along the lines of what customers of large financial institutions already experience today but are still for the most part unavailable to taxpayers.

The Oversight Board disagrees with the President's program reductions for taxpayer service and recommends that the following three initiatives be funded for a total of \$26.3 million:

- Maintain Processing of Critical Pension Plan Returns (\$6.3 million);
- Research Taxpayer Burden, Complexity, and Compliance (\$10 million); and
- Expand Volunteer Income Tax Assistance and Low Income Tax Clinics (\$10 million).

The first initiative supports customer service by providing funds to maintain processing of essential pension plan return information while transitioning to a new mandated electronic filing system "EFAST2" in 2010. It also enables processing of residual returns that are IRS-only forms and not part of the mandated EFAST2 system (Form 5500EZ and Schedule SSA filings).

The second initiative provides funding to enhance understanding of the interaction between taxpayer burden, tax law complexity, and taxpayer compliance. This research will help improve understanding of these inter-relationships, in keeping with strategies put forth in the Taxpayer Assistance Blueprint (TAB) and the Department of the Treasury report, *A Comprehensive Strategy for Reducing the Tax Gap*.

The third initiative provides funding to improve service to two taxpayer segments with special needs: the growing number of elderly and the ethnically diverse. These

taxpayer segments face unique challenges in meeting their tax obligations because of limited access to or inability to use all of the channels offered for service delivery. Additional resources will enhance the IRS's volunteer return preparation and other services provided by the Volunteer Income Tax Assistance (VITA) and the Low Income Tax Clinic programs with emphasis on both targeted taxpayer segments. Such services help created a more fair and just tax system.

*Strategic Goal 2—Enhance Enforcement of the Tax Law*

Increases in IRS enforcement activity intended to produce gains in direct revenue collection must be balanced with a broad view of the tax gap. The Board recognizes that increased enforcement activity over the past five years has produced noticeable results—enforcement revenue has increased from \$34.1 billion in fiscal year 2002 to \$59.2 billion in fiscal year 2007, a gain of nearly 74 percent. The IRS estimates that it can produce more than a four-to-one return on every dollar invested in additional enforcement resources, a fact that the Board believes warrants the appropriation of additional enforcement funding.

However, while the Board applauds the increases in enforcement activity and revenue, it also recognizes that the IRS cannot “audit its way out” of the tax gap. There is wide belief, as evidenced by the Board's recommendations for reducing the tax gap and the Treasury Department's tax gap strategy, A Comprehensive Strategy for Reducing the Tax Gap, that an integrated set of comprehensive actions is needed. Even a large infusion of resources for more enforcement personnel—something highly unlikely—would not eliminate the tax gap. There are many reasons for taxpayer non-compliance. Only a balanced program that promotes voluntary compliance across a broad continuum of taxpayers, from education and service for those who want to comply, to enforcement and even criminal prosecutions for those who refuse to comply, can be effective.

Table 2 compares the Board's and President's enforcement initiatives. Although very close in dollars, the President's initiatives place more emphasis on enforcement resources that can be shown to produce revenue in the short term. The Board takes a broader view of enforcement, and recommends program increases in such areas as expanded collection of proper taxes from recipients of Federal payments, investigation of tax-related criminal activity, Bank Secrecy Act compliance, tax exempt organization examination, more published guidance for Tax Exempt taxpayers, additional litigation staff, and tax preparer monitoring.

Additional enforcement resources produce a positive return on investment and result in short-term benefits, so the benefits of increased enforcement are apparent. However, increases in enforcement resources must also be balanced with more systemic long-range actions that improve voluntary compliance, and priorities must be considered as budget resources are limited. The Oversight Board considers technology modernization and research a higher priority than additional enforcement resources, in recognition of the long-term impact that technology modernization and research have on the IRS' ability to work more efficiently to reduce the tax gap and to be better able to focus both its service and enforcement resources optimally.

TABLE 2.—COMPARISON OF ENFORCEMENT INITIATIVES FOR BOARD'S AND PRESIDENT'S BUDGETS  
[Dollars in millions]

Oversight board's budget enforcement initiatives	Amount	President's budget enforcement initiatives	Amount
Reduce the Tax Gap for Small Business/Self-Employed .....	\$120.7	Reduce the Tax Gap for Small Business/Self-Employed.	\$168.50
Increase Reporting Compliance of Domestic Taxpayers with Offshore Activity.	16.4	Improve Reporting Compliance of U.S. Taxpayers with Offshore Activity.	13.70
Reduce the Tax Gap for Large Businesses .....	52.0	Reduce the Tax Gap for Large Business.	69.49
Expand Federal Payment Levy Program .....	17.3	.....	.....
Reduce Tax Fraud .....	72.2	.....	.....
Enhance Financial Investigations of Narcotics Trafficking Organizations.	24.0	.....	.....
Enhance BSA Compliance Program .....	3.4	.....	.....
Address Complexity through Up-Front Guidance, Education, and Correction.	8.9	.....	.....
Expand Examination of Tax Exempt Organizations .....	28.6	.....	.....
Increase Tax Court Litigation .....	5.8	.....	.....
Implement New Procedural Tax Court Requirements .....	3.4	.....	.....



TABLE 2.—COMPARISON OF ENFORCEMENT INITIATIVES FOR BOARD'S AND PRESIDENT'S BUDGETS—Continued  
[Dollars in millions]

Oversight board's budget enforcement initiatives	Amount	President's budget enforcement initiatives	Amount
Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance.	11.1	.....	51.06
Increase Monitoring of Preparers .....	2.5	.....	.....
.....	.....	Expand Document Matching .....	35.06
.....	.....	Implement Legislative Proposals to Improve Compliance.	23.05
Total Enforcement .....	366.3	.....	360.85

Another factor that must be considered is the degree to which additional staffing can be absorbed into various IRS organizational units. Figure 2 depicts the distribution of new hires in major IRS organizations under the President's and Board's budgets. The Board believes its budget strikes a more balanced posture across all IRS organizational units and expands enforcement resources for a range of activities that are important elements of IRS enforcement, although they do not generate revenue directly, such as examination of tax exempt organization reporting, regulation of pension plans, and criminal investigation of tax fraud and abusive tax shelters. These activities are all part of a balanced, enforcement program that has as a goal the promotion of voluntary compliance among all taxpayer segments.

To better understand the impact of both budgets on the Small Business/Self-Employed (SB/SE) and Large and Mid-Sized Business (LMSB) organizations, the Board examined hiring requirements during fiscal year 2009 for both divisions. Table 3 shows the number of Mission Critical Occupation (MCO) employees projected to be on-rolls as of September 30, 2008, as well as the hiring requirements contained in both budgets. The Board has used a rule of thumb that 15 percent new hires is a reasonable limit on the amount of new employees that can be effectively accommodated into an organization in a year. It had concerns with the hiring implications of its own budget on SB/SE, but thought this risk could be mitigated. The President's budget would increase the percentage of new hires in SB/SE to over 23 percent of its employees in fiscal year 2009, and over 16 percent for LMSB.

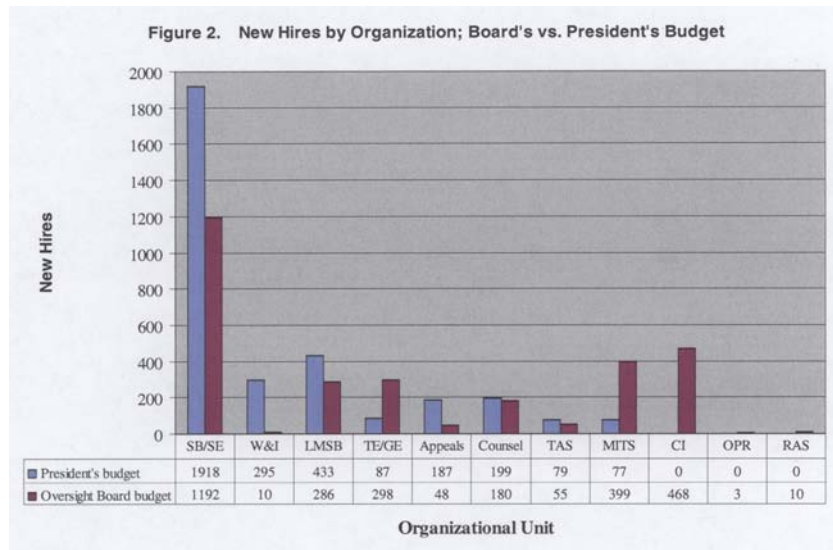


TABLE 3.—SB/SE AND LMSB HIRING REQUIREMENTS IN THE BOARD'S AND PRESIDENT'S FISCAL YEAR 2009 BUDGETS

	Operating Unit Mission Critical Occupations			
	Oversight board budget		President's budget	
	SB/SE	LMSB	SB/SE	LMSB
Projected on rolls as of 9/30/2008 .....	19,394	5,126	19,394	5,126
Projected Attrition Hires in fiscal year 2009 .....	2,612	403	2,612	403
Projected New Hires in fiscal year 2009 to Meet Budget Request .....	1,177	273	1,918	433
Total Attrition Hires and New Hires .....	3,789	676	4,530	836
Percent of Hires to total MCO population .....	19.5	13.2	23.4	16.3

As in fiscal year 2006 through fiscal year 2008, the administration proposes to include its requested enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The Oversight Board's recommended enforcement initiatives would also qualify for such treatment, should Congress decide to make such an adjustment.

*Strategic Goal 3—Modernize the IRS Through its People, Processes and Technology*

The most effective strategy for reducing the tax gap in the long term is to provide the IRS with modern technology that enables it to operate at a high performance level. The Board has no doubts that a high performing organization with high service, quality, and satisfaction levels also minimizes taxpayer burden. Under such conditions, service and enforcement activities are prompt, efficient, and correct.

The Board has identified program initiatives for IT and infrastructure activities that are funded under the BSM and Operations Support accounts. These initiatives will further modernize the IRS core IT systems used for tax administration, upgrade its infrastructure, and improve its security posture.

BUSINESS SYSTEMS MODERNIZATION PROGRAM INITIATIVE

Tax administration is a knowledge-intensive activity and the IRS depends heavily on information technology (IT) to leverage the knowledge and perform its mission. The IRS has made slow but steady progress in replacing its antiquated IT systems. The most noticeable improvements to taxpayers have been increased use of electronic products and services to interact with the IRS. However, the IRS' performance is still hampered by archaic IT systems used for central record-keeping that update taxpayer account information on a weekly instead of a daily basis.

The Board has long advocated that the BSM program be funded at a higher level so progress could be made more quickly. Admittedly the program experienced a series of cost and schedule overruns during its first several years, and the result has been to slow down the funding stream to levels that dictate only modest progress can be made in modernizing the core IRS master files and account management systems. Because of its long-term effect on reducing the tax gap, the Board considers increasing BSM funding so that the pace of IT modernization can be increased as having the highest priority.

Figure 3 compares the BSM budget recommended by the Oversight Board, the amount requested by the President, and the BSM funding appropriated by Congress for fiscal years 2003 to 2008. BSM funding needs to be restored to the levels realized in fiscal year 2003 and fiscal year 2004 to make progress faster.

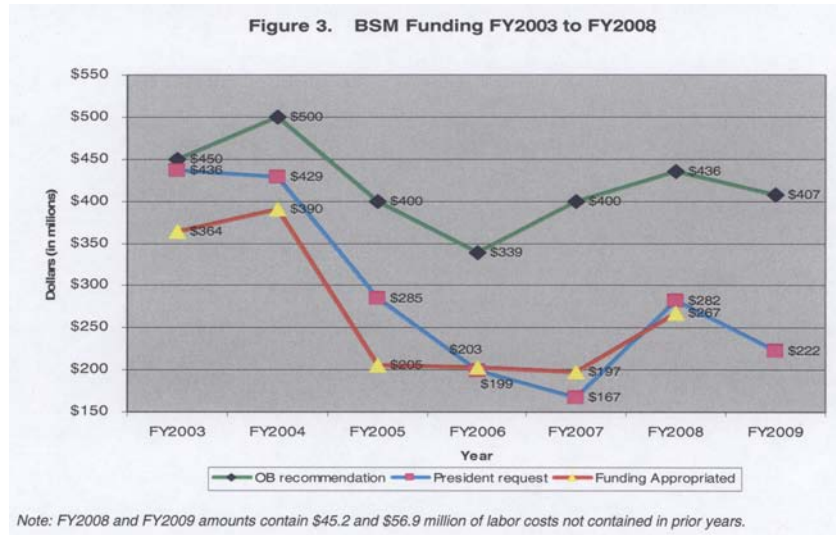


Table 4 shows the Board's and President's budgets for the BSM program in fiscal year 2009. Had the Board's funding recommendations been followed, the IRS would be closer to the day when it could update its central records on a daily basis.

**TABLE 4.—APPLICATION OF FISCAL YEAR 2009 BSM FUNDING TO PROJECTS IN THE IRS  
OVERSIGHT BOARD'S AND PRESIDENT'S BUDGETS**

[Dollars in millions]

Project activities	Fiscal year 2008	Oversight board		President	
		Fiscal year 2009	Increase over fiscal year 2008	Fiscal year 2009	Increase over fiscal year 2008
Customer Account Data Engine .....	58.5	80.0	21.5	58.8	0.3
Accounts Management Services .....	29.0	47.4	18.4	26.2	(2.8)
Modernized e-File .....	55.8	36.1	(19.7)	25.0	(30.8)
Common Services Project .....		16.0	16.0		
Integrated Financial System .....		73.0	73.0		
Core Infrastructure; Architecture Integration & Management; and Management Reserve .....	78.6	98.1	19.5	69.3	(9.3)
Subtotal Capital Investments .....	221.8	350.6	128.8	179.3	(42.6)
BSM Labor .....	45.2	56.7	11.5	43.4	(1.8)
<b>BSM Program Total .....</b>	<b>267.1</b>	<b>407.3</b>	<b>140.2</b>	<b>222.7</b>	<b>(44.4)</b>

Note: BSM program excludes \$1.2 million of corporate costs in Operations Support.

The Board believes that when implemented, modernized IT systems will literally save taxpayers billions of dollars in burden reduction and make the IRS much more efficient. For example, replacement of the Individual Master File by the Customer Account Data Engine (CADE) will allow the IRS to update the tax accounts for individuals on a daily basis, instead of its current weekly update process. The Oversight Board expects that a rapid refund from the IRS of 3 to 5 days will reduce the number of Refund Anticipation Loans (RALs). The National Consumer Law Center and Consumer Federation of America estimate that approximately 12 million American taxpayers spent an unnecessary \$1.6 billion on RALs in 2004 (the latest year for which data is available) to obtain their refund monies faster by 2 weeks. Moreover, daily updating of account records will give IRS employees and taxpayers access to the most current taxpayer account data, eliminating the problems associated with having various data bases with less than current status. The Oversight Board ex-

pects that daily posting of account information will improve the IRS' analysis capability and greatly reduce the burdens associated with the account resolution process.

The Modernized e-File system not only makes it easier for taxpayers to file tax returns with the IRS, it reduces the human resources needed to receive and process tax returns and eliminates the error-prone transcription process. For corporate filers, it helps the LMSB division improve currency and cycle time in working large corporate tax cases. When implemented for individual tax returns, it will make the electronic filing process even simpler than it is today with the current legacy electronic filing system.

The Integrated Financial System (IFS) will provide necessary improvements to the system the IRS uses to manage its financial resources, clearly a must for any agency, especially one that is responsible for managing taxpayers' accounts as well as its own appropriated resources. The IFS upgrade is needed to ensure that the IRS remains in compliance with Federal accounting and other financial management requirements. The additional funding for the IFS initiative will enable the IRS to add procurement and asset management modules to the existing IFS application and integrate related business processes with core accounting and financial management operations. The funding will also provide for the subsequent transfer of IFS to a Shared Service Center and thereby maintain its longer term viability.

The Board believes that funding for the BSM program should be accelerated, not slowed down. Failure to fund the IRS BSM program at higher levels, in the view of the Board, is a case of being penny-wise and pound foolish.

#### INFORMATION TECHNOLOGY/INFRASTRUCTURE PROGRAM INITIATIVES

The IRS must be held to the highest standards for security and data integrity while increasing its engagement in the electronic world in which most taxpayers already live. Meeting this dual challenge of high security and a high degree of electronic interaction with taxpayers demands that the IRS have a modern information systems and infrastructure.

The Board recommends six program initiatives for a total of \$103 million that will improve the IRS' operations by allowing it to make critical improvements to its technology and personnel infrastructure. By comparison, the President's budget contains no initiatives for IRS infrastructure.

Three of the initiatives, totaling \$32.2 million, enhance the IRS' security posture as the way the IRS does business continues to evolve and security threats seem to increase on a daily basis. Data security has taken on an expanded meaning in a post-9/11 world. Terrorists from around the globe are actively working to exploit weaknesses in Government IT security systems with the intent of producing both great physical and economic harm. Disrupting IRS returns processing and stealing sensitive information could wreak havoc on the economy and financial markets. The IRS cannot be complacent with respect to security, and the Board recommends the following security initiatives:

- Enhance IT Security (\$16.7 million);
- Enhance Contingency Planning and Disaster Recovery (\$8.7 million); and
- Implement Security Auditing (\$6.8 million).

The first initiative enables the IRS to further implement key IT security and privacy safeguards to assure the integrity of sensitive taxpayer and employee data and supporting infrastructure processes. Protecting taxpayer data is paramount. The second initiative is to enhance the IRS enterprise-wide contingency planning and disaster recovery capabilities to support critical business systems. Any unavailability of critical IRS business systems poses an unacceptably high risk to the Nation's security. The third initiative, Security Auditing, will allow the IRS to more effectively monitor key networks and systems to identify any unauthorized activities.

The remaining three initiatives, for a total of \$71.3 million, allow the IRS to improve other elements of its infrastructure. They are:

- Redesign Form 990 for Tax Exempt Organizations (\$23.5 million);
- Preserve Quality IT Workforce in Applications Development (\$36.8 million); and
- Build Alternate Power Supply for the Computing Centers (\$11 million).

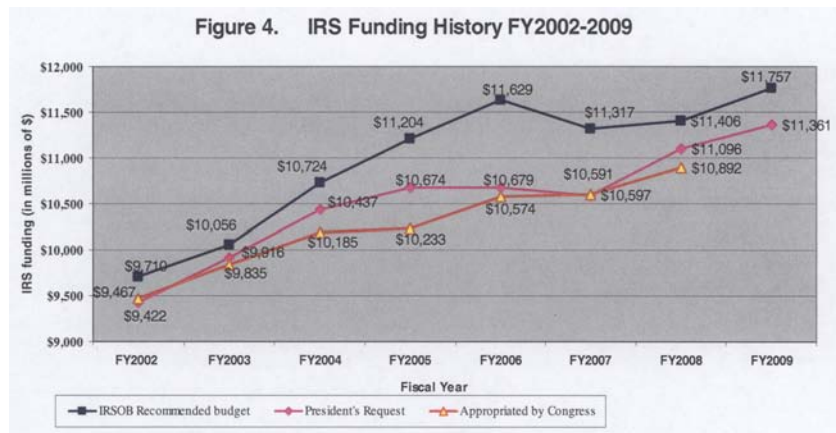
The first initiative, the only one that is not considered high priority, is recommended because it brings new efficiencies to tax filing for a segment of taxpayers who are frequently ignored because their tax returns do not produce revenue—tax exempt organizations. The Form 990 tax return is difficult to complete for tax exempt organizations to complete and for reviewers to comprehend. Worse, it fails to provide the IRS with sufficient information to detect and analyze compliance trends in the sector and target enforcement actions as needed.

The second initiative will give the IRS better tools to retain its IT workforce by mitigating intellectual and experiential loss through a series of supporting strategies such as workforce re-tooling, succession planning, and retention. The third initiative provides alternate power supply for three of the IRS's computing centers. Currently there is but a single power supply facility at each of the computing centers. An alternate power supply capability at each of the three computing centers would ensure the continuous operation of, and continuous access to, tax processing systems at the computing centers during unplanned emergencies and planned power supply tests, and avoid the revenue loss and overtime expense associated with the current process that requires total shut down periods.

#### INVESTING IN IRS IS A GOOD BUSINESS DECISION SUPPORTED BY THE PUBLIC

In spite of recommendations made by the IRS Oversight Board, the IRS has not been funded at the most effective levels to achieve its strategic objectives. Figure 4 illustrates funding recommendations made by the Board since its inception, the President's budget request during this same time frame, and the funding appropriated by Congress. One of the principal reasons for this so-called "resource gap" is the budget process which treats the IRS the same as it does all other discretionary spending requests. It does not credit the IRS with bringing in 95 percent of all the revenue to fund the Federal Government, nor does it recognize the previously discussed four-to-one return on every dollar invested in tax enforcement.

The Oversight Board has urged previously Congress to view funding of the IRS as an investment.<sup>1</sup> Other members of the tax administration community, such as the National Taxpayer Advocate and the National Treasury Employees Union, have made similar recommendations.<sup>2</sup>



There are a number of approaches that Congress could take to achieve this result, such as funding the IRS outside of budget caps, and the Board believes that the implementation of such a change is best left for Congress to decide. The Board would be remiss, however, if it didn't point out providing additional funds to the IRS has been consistently supported by nearly two out of three members of the public. In its annual Taxpayer Attitude Survey, the Board has asked taxpayers whether they support additional funding for the IRS. The results for 2005 through 2007 are shown in Table 5.

<sup>1</sup> IRS Oversight Board reports, *Fiscal Year 2006 IRS Budget Recommendations/Special Report*, *Fiscal Year 2007 IRS Budget Recommendations/Special Report*, and *Fiscal Year 2008 IRS Budget Recommendations/Special Report*.

<sup>2</sup> NTA, *2006 Report to Congress*, Section 2, p. 445, and Statement of Colleen M. Kelley, President, National Treasury Employees Union, Testimony Before the House Committee on Ways and Means, May 23, 2007.

TABLE 5.—RESULTS OF TAXPAYER ATTITUDE SURVEY ON IRS FUNDING

Survey question 11	Percent completely agree			Percent mostly agree		
	2007	2006	2005	2007	2006	2005
The IRS should receive extra funding to enforce tax laws and ensure taxpayers pay what they owe .....	24	24	20	40	39	43
The IRS should receive extra funding so it can assist more taxpayers over the phone and in person .....	21	24	22	42	42	44

The Board believes such strong support indicates the public understands the need for effective tax administration and realizes that, ultimately, it pays for itself.

## CONCLUSION

Approving a budget is not just about money; it's also about choices. The Board believes its budget recommendations, if implemented, will put the IRS on an effective long-term path to achieving the IRS strategic goals, improving voluntary compliance, and reducing the tax gap.

Although the Board's recommended budget is \$375 million more than the President's request, there are some important decisions that must be made with respect to priorities and balance. The Congress must not only decide the amounts to be appropriated, but must also choose whether it wants to pursue short-term growth in enforcement activity over a more balanced path that stresses the benefits of long-term investments in technology, infrastructure, service, and research.

## APPENDIX A.—IRS OVERSIGHT BOARD RECOMMENDED IRS FISCAL YEAR 2009 BUDGET

TABLE A-1.—IRS OVERSIGHT BOARD'S RECOMMENDED FISCAL YEAR 2009 IRS BUDGET BY PROGRAM INITIATIVE  
[In millions of dollars]

	Amount
Fiscal Year 2008 Enacted Appropriation .....	10,892.38
Base Adjustments .....	262.62
Savings/Reinvestments .....	(61.65)
Fiscal Year 2008 Base Budget .....	11,093.35
INITIATIVES	
Enforcement:	
Reduce the Tax Gap for Small Business/Self-Employed .....	120.7
Increase Reporting Compliance of Domestic Taxpayers with Offshore Activity .....	16.4
Reduce the Tax Gap for Large Businesses .....	52.0
Expand Federal Payment Levy Program .....	17.3
Reduce Tax Fraud .....	72.2
Enhance Financial Investigations of Narcotics Trafficking Organizations .....	24.0
Enhance BSA Compliance Program .....	3.4
Address Complexity through Up-Front Guidance, Education, and Correction Opportunities .....	8.9
Expand Examination of Tax Exempt Organizations .....	28.6
Increase Tax Court Litigation .....	5.8
Implement New Procedural Tax Court Requirements .....	3.4
Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance .....	11.1
Increase Monitoring of Preparers .....	2.5
Total Enforcement .....	366.3
Taxpayer Services:	
Maintain Processing of Critical Pension Plan Returns .....	6.3
Research Taxpayer Burden, Complexity, and Compliance .....	10.0
Expand Volunteer Income Tax Assistance and Low Income Tax Clinics .....	10.0
Total Service .....	26.3

TABLE A-1.—IRS OVERSIGHT BOARD'S RECOMMENDED FISCAL YEAR 2009 IRS BUDGET BY  
PROGRAM INITIATIVE—Continued

[In millions of dollars]

	Amount
Infrastructure/IT:	
Enhance IT Security .....	16.7
Enhance Contingency Planning and Disaster Recovery .....	8.7
Implement Security Auditing .....	6.8
Redesign Form 990 for Tax Exempt Organizations .....	23.5
Preserve Quality IT Workforce in Applications Development .....	36.8
Build Alternate Power Supply for the Computing Centers .....	11.0
Infrastructure/IT Initiatives Subtotal .....	103.5
Business Systems Modernization (BSM) .....	142.4
HITCA .....	5.50
Total Initiatives .....	644.00
Fiscal Year 2009 Budget Request .....	11,737.35
Fiscal Year 2009 Request Increase over Fiscal Year 2008 Base .....	844.97
Fiscal Year 2009 President's Request for IRS .....	11,361.51
Increase Over President's Budget Request .....	375.8

TABLE A-2.—IRS OVERSIGHT BOARD'S RECOMMENDED FISCAL YEAR 2009 IRS BUDGET BY APPROPRIATION ACCOUNT  
[In millions of dollars]

	Taxpayer serv- ices	Enforcement	Ops support	BSM	HITCA	Total
Fiscal Year 2008 Enacted Appropriation .....	2,150.0	4,780.0	3,680.1	267.1	15.2	10,892.4
Base Adjustments .....	54.7	125.0	81.2	1.4	0.3	262.6
Savings/Reinvestments .....	(10.5)	(48.8)	(2.2)	.....	(0.2)	(61.6)
Fiscal Year 2009 Base Budget .....	2,194.2	4,856.2	3,759.0	268.4	15.4	11,093.4
<b>INITIATIVES</b>						
<b>Enforcement:</b>						
Reduce the Tax Gap for Small Business/Self-Employed .....	2.9	94.0	23.8	.....	.....	120.7
Increase Reporting Compliance of Domestic Taxpayers with Offshore Activity .....	.....	13.8	2.6	.....	.....	16.4
Reduce the Tax Gap for Large Businesses .....	.....	44.0	8.0	.....	.....	52.0
Expand Federal Payment Levy Program .....	0.4	16.5	0.4	.....	.....	17.3
Reduce Tax Fraud .....	.....	55.8	16.4	.....	.....	72.2
Enhance Financial Investigations of Narcotics Trafficking Organizations .....	.....	21.0	3.0	.....	.....	24.0
Enhance BSA Compliance Program .....	.....	2.8	0.6	.....	.....	3.5
Address Complexity through Up-Front Guidance, Education, and Correction Opportunities .....	1.1	6.5	1.3	.....	.....	8.9
Expand Examination of Tax Exempt Organizations .....	0.2	23.3	5.1	.....	.....	28.6
Increase Tax Court Litigation .....	.....	5.0	0.8	.....	.....	115.8
Implement New Procedural Tax Court Requirements .....	.....	2.8	0.5	.....	.....	3.4
Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance .....	.....	7.6	3.5	.....	.....	11.1
Increase Monitoring of Preparers .....	.....	2.2	0.4	.....	.....	2.5
Total Enforcement .....	4.7	295.2	66.5	.....	.....	366.3
<b>Taxpayer Services:</b>						
Maintain Processing of Critical Pension Plan Returns .....	6.0	.....	0.2	.....	.....	6.3
Research Taxpayer Burden, Complexity, and Compliance .....	.....	.....	10.0	.....	.....	10.0
Expand VITA and Low Income Tax Clinics .....	9.8	.....	0.2	.....	.....	10.0
Total Service .....	15.8	.....	10.5	.....	.....	26.3
<b>Infrastructure/IT:</b>						
Enhance IT Security .....	.....	.....	16.7	.....	.....	16.7



Enhance Contingency Planning and Disaster Recovery .....	.....	.....	.....	.....	8.7	.....	.....	8.7
Implement Security Auditing .....	.....	.....	.....	.....	6.9	.....	.....	6.9
Redesign Form 990 for Tax Exempt Organizations .....	.....	.....	.....	.....	23.5	.....	.....	23.5
Preserve Quality IT Workforce .....	.....	.....	.....	.....	36.8	.....	.....	36.8
Build Alternate Power Supply for the Comp Centers .....	.....	.....	.....	.....	11.0	.....	.....	11.0
Infrastructure/IT Initiatives Subtotal .....	.....	.....	.....	.....	103.5	.....	.....	103.5
Business Systems Modernization (BSM) .....	.....	.....	.....	.....	1.2	141.2	.....	142.4
HITCA .....	.....	.....	.....	.....	.....	.....	5.5	5.5
Total Initiatives .....	20.5	295.2	.....	181.6	141.2	.....	5.5	644.0
Fiscal Year 2009 Budget Recommendation .....	2,214.7	5,151.4	3,940.6	409.7	20.9	.....	.....	11,737.4
Fiscal Year 2009 Recommendation over Fiscal Year 2008 Enacted .....	64.7	371.4	260.6	142.6	5.7	.....	.....	845.0
Fiscal Year 2009 President's Request for IRS .....	2,150.0	5,117.3	3,856.2	222.7	15.4	.....	.....	11,361.5
Increase Over President's Budget Request .....	64.7	34.2	84.5	187.0	5.5	.....	.....	375.9

Senator DURBIN. Taxpayer Advocate, Nina Olson.

**STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE**

Ms. OLSON. Chairman Durbin, Ranking Member Brownback, and members of the subcommittee, thank you for inviting me to testify on the proposed budget of the IRS for fiscal year 2009.

As an initial matter, I want to acknowledge that the IRS is doing an excellent job with most of its core services as illustrated by its ability to pull off the recent filing season despite the late AMT patch and the need to apply its limited resources to providing stimulus payments. There are always tasks the IRS could perform better and I will address some of those today, but I think it is important to take a moment to reflect on the vast responsibilities the IRS must meet to collect the revenue our Government requires to function and to acknowledge how much the IRS does very well.

Now, I would like to emphasize five points.

First, in my 2006 annual report to Congress, I recommended that Congress provide the IRS with after-inflation budget increases of about 2 to 3 percent a year for the foreseeable future. Assuming the funds are wisely spent, I believe that each additional dollar appropriated for the IRS will generate substantially more than \$1 in increased Federal revenue. Providing adequate funding for the IRS, which is in reality the accounts receivable department of the Federal Government, is a wise financial investment.

Second, one of the most critical choices facing tax administration is how to allocate resources between taxpayer services and tax law enforcement. While I believe that both categories would benefit from additional funding, I am concerned that the IRS has been emphasizing enforcement at the expense of taxpayer services. Over the 5-year period, fiscal year 2004 through fiscal year 2008, GAO concluded that funding for enforcement has increased substantially while funding for taxpayer services has been reduced. The budget proposal for fiscal year 2009 would continue this trend.

Moreover, while the taxpayer services appropriation is currently \$2.2 billion, more than 70 percent of those funds are used for filing and account services, mostly the processing of tax returns. Return processing is not pure taxpayer service but also constitutes the first step in screening returns for audit. The budget subcategory titled "pre-filing taxpayer assistance and education" is what most people think of as core taxpayer service, and significantly, only 6 percent—6 percent—of the IRS budget, or \$645 million, is currently devoted to this area. The budget proposal would reduce this \$645 million taxpayer service amount by about \$28 million, a reduction of 4.35 percent in nominal terms and a larger reduction after taking into account inflation.

There are no reliable data that show that more enforcement is more effective than more taxpayer service in increasing compliance. I believe the IRS can produce a positive return on investment from more funding in both areas, but given limited resources, I think it is misguided to continue to ramp up enforcement at the expense of providing core taxpayer services.

Third, research plays a vital role in helping the IRS make the major strategic and operational decisions needed to effectively ad-

minister the tax system. Just as research and development (R&D) is critical to a technology company as it seeks to improve the products and services it provides to customers, tax administration-related research is critical to the IRS as it seeks to meet taxpayer service needs and improve tax compliance in a cost effective manner. For that reason, I have consistently advocated for a more robust IRS research capability.

The Taxpayer Advocate Service has initiated or worked with the IRS to conduct taxpayer-centric research on several enforcement and service issues. Some of these projects have been undertaken in response to appropriations directives and they are detailed in my written statement.

In my annual reports to Congress and in prior testimony, I have expressed serious concerns about many aspects of the private debt collection initiative. I now add to these concerns the issue of foregone revenue. Very simply, the PDC initiative will cost the Government more than \$81 million in foregone revenue this year, and the cost is likely to reach nearly \$500 million over the next 6 years. Moreover, 46 percent of the fully paid liabilities included in PDC gross revenue have been collected through offsets or direct payments made by the taxpayer after receiving a letter from the IRS informing the taxpayer that his or her account would be placed with a private collection agency (PCA), but before the PCA made contact with the taxpayers. These fully paid liabilities are a direct result of IRS action, not action taken by the PCA. Although the purpose of the private debt collection (PDC) program is obviously to raise revenue, the PDC program has lost revenue in absolute terms and will continue to cost the Government significant foregone revenue each year.

I will make my fifth point in my written statement so I am not penalized.

Senator DURBIN. Thank you very much, Ms. Olson.

[The statement follows:]

#### PREPARED STATEMENT OF NINA E. OLSON

Mr. Chairman, Ranking Member Brownback, and distinguished Members of the Subcommittee: Thank you for inviting me to submit this written statement regarding the proposed budget of the Internal Revenue Service (IRS) for fiscal year 2009. I will address the overall level of funding I believe the IRS should receive, the allocation of that funding between enforcement and taxpayer service, and a number of important tax administration issues in which this Committee has expressed an interest. I approach these issues from my perspective as the National Taxpayer Advocate, the voice for taxpayers and taxpayer rights inside the IRS.<sup>1</sup>

As a threshold matter, I want to acknowledge that the IRS is doing an excellent job with most of its core services, and it is seriously attempting to improve its operations in other areas. This filing season alone demonstrates that when the IRS devotes its full attention to a task, it performs it extraordinarily well. As I noted in my 2007 Annual Report, late-year tax-law changes impact both taxpayers and the IRS, and the uncertainty surrounding such changes increases the risk that problems

<sup>1</sup> The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

will arise with basic service delivery and return processing.<sup>2</sup> These challenges increase when the IRS must devote substantial resources during the filing season to a major new initiative, such as preparing to issue the recently authorized economic stimulus payments. To deliver these payments, the IRS not only must process payments to the over 130 million taxpayers who currently file income tax returns, but it also must identify and process returns from and payments to more than 20.5 million persons who have no filing requirement.<sup>3</sup> All of these exigencies divert the IRS from other important work, yet the fact that the IRS has managed to turn on a dime and deliver this filing season without significant glitches is a testament to the extraordinary people who work at the IRS.

There are always tasks the IRS could perform better—and I will address some of them below—but I think it is important to take a moment to reflect on the vast responsibilities the IRS must meet to collect the revenue our Government requires to function and to acknowledge how much the IRS does very well.

*To Increase Federal Revenue, Congress Should Provide Increases in IRS Personnel Funding at a Rate of About Two Percent to Three Percent a Year Above Inflation*

In my 2006 Annual Report to Congress, I recommended that Congress provide the IRS with after-inflation increases of about 2 percent to 3 percent a year for the foreseeable future. Assuming the funds are wisely spent, I said that I believe increasing the IRS budget at this rate is an excellent financial investment. I continue to believe this is the case.

Most Federal expenditure programs are just that—expenditure programs. The funds are intended to be spent on worthwhile programs, but the expenditures generally do not directly generate more Federal revenue.

The IRS is different. The IRS is effectively the Accounts Receivable Department of the Federal Government, and it collects about 96 percent of all Federal revenue.<sup>4</sup> On a budget of about \$10.6 billion,<sup>5</sup> the IRS collected about \$2.24 trillion in fiscal year 2006.<sup>6</sup> In other words, every \$1 spent on the IRS produced about \$210 in Federal revenue.<sup>7</sup>

If the Federal Government were a private company, its management clearly would fund the Accounts Receivable Department at whatever level it believed would maximize the company's bottom line. Since the IRS is not a private company, maximizing the bottom line is not—in and of itself—an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Studies show that if the IRS were given more resources, it could collect substantially more revenue.

In his final report to the IRS Oversight Board in 2002, former Commissioner Charles Rossotti presented a discussion titled “Winning the Battle but Losing the War” that detailed the consequences of the lack of adequate funding for the IRS. He identified 11 specific areas in which the IRS lacked resources to do its job, including taxpayer service, collection of known tax debts, identification and collection of tax from non-filers, identification and collection of tax from underreported income, and noncompliance in the tax-exempt sector.

Commissioner Rossotti provided estimates of the revenue cost in each of the 11 areas based on IRS research data. In the aggregate, the data indicated that the IRS

<sup>2</sup>See National Taxpayer Advocate 2007 Annual Report to Congress 3–12 (Most Serious Problem: The Impact of Late-Year Tax-Law Changes on Taxpayers).

<sup>3</sup>Approximately 20.5 million persons received Social Security or Veterans benefits and are therefore likely to qualify for stimulus payments but did not file tax returns in 2006. IRS News Release, *Special Economic Stimulus Payment Packages Go to Social Security, Veterans Recipients*, IRS–2008–37 (Mar. 10, 2008). There is also an unknown number of low income taxpayers who ordinarily would not have a filing requirement but will have to file this year to receive stimulus payments.

<sup>4</sup>Government Accountability Office, GAO–07–136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 84 (Nov. 2006).

<sup>5</sup>Department of the Treasury, *Fiscal Year 2007 Budget in Brief* at 59.

<sup>6</sup>Government Accountability Office, GAO–07–136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* at 95 (Nov. 2006). The IRS actually collected \$2.51 trillion on a gross basis in fiscal year 2006, but issued \$277 billion in tax refunds.

<sup>7</sup>When collecting tax from the vast majority of taxpayers who file returns and pay all or substantially all of the tax they owe voluntarily, the cost the IRS incurs per taxpayer is very low. As the IRS attempts to collect tax from noncompliant taxpayers through broader outreach efforts or through examination and collection actions, the cost per taxpayer rises substantially. Therefore, the *marginal* ROI the IRS achieves as it attempts to collect unpaid taxes is likely to be considerably lower than the *average* ROI of 210:1 that the IRS achieves on taxes paid voluntarily. But if the IRS were given more resources, most data indicate that the IRS could generate a substantially positive marginal ROI.

lacked the resources to handle cases worth about \$29.9 billion each year. It placed the additional funding the agency would have needed to handle those cases at about \$2.2 billion.<sup>8</sup>

Significantly, this estimate reflected only the potential direct revenue gains. Economists have estimated that the indirect effects of an examination on voluntary compliance provide further revenue gains. While the indirect revenue effects cannot be precisely quantified, two of the more prominent studies in the area suggest the indirect revenue gains are between 6 and 12 times the amount of a proposed adjustment.<sup>9</sup>

I want to emphasize that the existing modeling in this area is not especially accurate, and estimates of both the direct and indirect effects of IRS programs vary considerably. As I will discuss below, the IRS needs to develop better modeling to produce more accurate return-on-investment estimates. But I also want to emphasize that almost all studies show that, within reasonable limits, each additional dollar appropriated to the IRS should generate substantially more than an additional dollar in Federal revenue, assuming the funding is wisely spent.

*The IRS Currently Spends Only Six Percent of Its Budget on Taxpayer Assistance and Education; a More Equitable Balance Between Taxpayer Services and Enforcement Should Be Achieved*

One of the most critical choices facing tax administration is how to allocate resources between taxpayer services and tax-law enforcement. While I believe that both categories would benefit from additional funding—and I do not believe the categories should be viewed as mutually exclusive—I am concerned that the IRS has been emphasizing enforcement at the expense of taxpayer service.

After the administration issued its fiscal year 2008 budget proposal last year, the GAO analyzed recent IRS funding trends. Over the 5-year period fiscal year 2004 through fiscal year 2008, it concluded that funding for enforcement has increased substantially while funding for taxpayer services has been reduced. Based on the administration's proposal for fiscal year 2008, it pointed out that funding over the fiscal year 2004 through fiscal year 2008 period would increase by 19.4 percent for enforcement while funding for taxpayer services would decline by 3.8 percent.<sup>10</sup> The final appropriations bill for fiscal year 2008 made a modest adjustment to the administration's proposal, providing about \$46.9 million more for taxpayer service and \$145 million less for enforcement.<sup>11</sup>

However, the proposal for fiscal year 2009 would continue the trend of spending relatively more on enforcement. The pending budget proposal would increase enforcement spending by \$490 million (7 percent), while increasing spending for taxpayer services by only \$23 million (0.6 percent).<sup>12</sup> Thus, after inflation, the proposal would reduce taxpayer services spending still further.

Moreover, the budget categories of "Taxpayer Services" and "Enforcement" are misleading. Of the \$2.2 billion in the "Taxpayer Services" category, only \$645 million, or 6 percent of the IRS budget, is currently allocated for "Pre-filing Taxpayer Assistance and Education."<sup>13</sup> A significant majority of funds under the "Taxpayer Services" category is allocated for "Filing and Account Services," which largely covers the processing of tax returns. Returns processing is hardly a pure service activity. While it does enable the IRS to issue tax refunds, it is an internal processing function that also constitutes the first step in screening returns for audit. In any event, it is far removed from the type of taxpayer service that informs taxpayers about their tax obligations and assists them in complying with the laws. The budget proposal would reduce funding for taxpayer assistance and education from \$645 mil-

<sup>8</sup> Commissioner Charles O. Rossotti, Report to the IRS Oversight Board: Assessment of the IRS and the Tax System 16 (Sept. 2002).

<sup>9</sup> Alan H. Plumley, Pub. 1916, The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness 35-36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986, 43 Nat. Tax J. 395, 396, 405 (1990).

<sup>10</sup> Government Accountability Office, GAO-07-673, *Internal Revenue Service: Interim Results of the 2007 Tax Filing Season and the Fiscal Year 2008 Budget Request* 27 (April 2007). These numbers are apparently not adjusted for inflation. GAO reported that overall IRS funding would increase, on an inflation-adjusted basis, by a mere 0.5 percent from fiscal year 2004 to fiscal year 2008 under the Administration's proposal. *Id.* at 26.

<sup>11</sup> Compare Department of the Treasury, *Fiscal Year 2009 Budget in Brief* at 53 with Department of the Treasury, *Fiscal Year 2008 Budget in Brief* at 55.

<sup>12</sup> Department of the Treasury, *Fiscal Year 2009 Budget in Brief* at 54. These dollar amounts reflect the allocation of the Operations Support budget to the Taxpayer Services and Enforcement categories.

<sup>13</sup> *Id.* at 53.

lion to \$617 million—a reduction of 4.34 percent in nominal terms and a larger reduction after taking into account inflation.<sup>14</sup>

I am deeply concerned about this long-term shift in the balance between taxpayer services and enforcement and the fact that only 6 percent of the IRS budget is devoted to pre-filing taxpayer assistance and education, which I view as core taxpayer service. There is no reliable data showing that more enforcement is more effective than more taxpayer service in increasing compliance. I believe the IRS can produce a positive return on investment from more funding in both areas. But given limited resources, I think it is misguided to continue to ramp up enforcement at the expense of taxpayer service.

The concerns I am expressing about the relative shift in emphasis from taxpayer service to enforcement do not reflect simply the misgivings of a zealous taxpayer advocate. My concerns are shared by former IRS Commissioner Rossotti. In a memoir about his experience running the IRS from 1997 to 2002, Mr. Rossotti wrote:

Some critics argue that the IRS should solve its budget problem by reallocating resources from customer support to enforcement. In the IRS, customer support means answering letters, phone calls, and visits from taxpayers who are trying to pay the taxes they owe. Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money.<sup>15</sup>

At his confirmation hearing, Commissioner Shulman said that he believes the choice between service and enforcement is a “false choice” because the IRS must do both well.<sup>16</sup> I agree completely. But the IRS needs adequate funding in both areas to do the job.

*The IRS Has Improved Its Research in Recent Years, But Significant Improvements Are Still Needed*

Research plays a vital role in helping the IRS make the major strategic and operational decisions needed to effectively administer the tax system. Just as R&D is critical to a technology company as it seeks to improve the products and services it provides to customers, tax administration-related research is critical to the IRS as it seeks to meet taxpayer service needs and improve tax compliance in a cost-effective manner. For that reason, I have consistently advocated for a more robust IRS research capability.

The IRS has more information available today than it did 5 years ago, particularly in the area of taxpayer service because of ongoing work in connection with the Taxpayer Assistance Blueprint. However, the IRS should continue to expand its available knowledge and should make research an integral part of its next strategic plan. In particular, the IRS should make it a priority to improve the accuracy of its return on investment (ROI) estimates for various categories of work, particularly taxpayer service and the indirect effect of enforcement actions. Improved methods should also be developed to verify, retrospectively, the marginal ROI that the IRS has achieved for major categories of its work. Such information would be extremely helpful in guiding future resource-allocation decisions.

Because of the value I place on research, TAS has initiated or worked with the IRS to conduct taxpayer-centric research on enforcement and service issues. Some of these projects have been undertaken in response to Appropriations directives. For example, TAS Research is currently working with the central IRS research function and the research functions in the IRS’s Wage & Investment and Small Business/Self-Employed Divisions to develop and implement a 5-year research plan to enhance taxpayer service in support of the Taxpayer Assistance Blueprint initiative. TAS Research is collaborating with the IRS research community to develop a 5-year research plan directly supporting enterprise-wide strategic goals. TAS Research is working with the central IRS research function to identify and quantify the numerous factors that impact taxpayer compliance behavior. TAS Research is working with the Office of Electronic Tax Administration and Refundable Credits to study alternatives for increasing electronic filing, and will work with the IRS’s National Research Program to conduct research into the causes of noncompliance (whether advertent or inadvertent).

In addition, TAS Research is involved in a number of other initiatives addressing significant tax administration issues, such as:

<sup>14</sup> Department of the Treasury, *Fiscal Year 2009 Budget in Brief* at 53.

<sup>15</sup> Charles O. Rossotti, *Many Unhappy Returns: One Man’s Quest to Turn Around the Most Unpopular Organization in America* 285 (2005).

<sup>16</sup> Hearing Before the S. Comm. on Finance, 110th Cong. (2008) (Jan. 29, 2008) (statement of Douglas H. Shulman).

- A collaborative effort with the research function in the Wage & Investment Division to explore development of a filter for the Federal Payment Levy Program to protect low income taxpayers from systemic levies;
- A collaborative effort with the Office of Program Evaluation and Risk Analysis (OPERA) to explore new applications of “agent-based modeling,” a technology that simulates taxpayer behavior in social networks, to tax administration issues;<sup>17</sup>
- A collaborative effort with the IRS research community to explore ways to positively influence the impact practitioners and preparers have on taxpayer compliance; and
- Ongoing research by an independent contractor into the impact preparers have on taxpayer compliance.<sup>18</sup>

In Volume 2 of the 2007 National Taxpayer Advocate’s Annual Report to Congress, I published a comprehensive literature review of the cognitive and normative factors that influence taxpayer compliance behavior.<sup>19</sup> In another section of the report, I adopt the central recommendation of the study—that the IRS should establish a cognitive learning and applied research laboratory to explore how taxpayer values, social norms, and cognitive processes influence taxpayers’ compliance.<sup>20</sup>

Toward that end, TAS Research is proposing a survey conducted as a component of the National Research Program (NRP), in which an independent firm surveys taxpayers who were subjects of NRP audits and explores the causes of any detected noncompliance and the factors influencing taxpayer compliance behavior. This information, combined with the compliance data from the NRP audits themselves and the observations of IRS auditors about the reasons for the detected noncompliance, should provide a rich resource for future studies and initiatives, and should improve the IRS’s ability to improve taxpayer compliance.<sup>21</sup>

I cite these studies as important examples of research studies that I hope and expect will improve the IRS’s ability to serve taxpayers and collect revenue. However, these studies are merely a starting point. If the IRS has better information, it can make more informed resource allocation decisions. Absent clear information, the IRS unavoidably bases its resource allocation decisions on intuition and bases its best guesses on incomplete data, and that is obviously not an ideal way to make decisions.

*The IRS Is Paying More Attention to Taxpayer Services, But Significant Challenges Remain*

In 2006, Congress directed the IRS to prepare a Taxpayer Assistance Blueprint (TAB), which was released last April.<sup>22</sup> The TAB was intended to serve as a strategic plan for taxpayer service and lead to the development of taxpayer-centric, research-based models to help the IRS make decisions about taxpayer service and the delivery of face-to-face service. Because of the TAB and my own office’s research,

<sup>17</sup> National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Study: Simulating EITC Filing Behaviors: Validating Agent Based Simulation for IRS Analyses: The 2004 Hartford Case Study).

<sup>18</sup> National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Study: Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws).

<sup>19</sup> National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Study: Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers).

<sup>20</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 158 (Most Serious Problem: Taxpayer Service and Behavioral Research).

<sup>21</sup> For an example of how one might conduct such a study and an interesting analysis of some of the attitudinal and knowledge factors that might impact taxpayer compliance in a self-assessment tax system, see Ern Chen Loo, Margaret McKerchar, & Ann Hansford, *An International Comparative Analysis of Self-Assessment: What Lessons are there for Tax Administrators?*, 20 Australian Tax Forum 667 (2005).

<sup>22</sup> H. Rep. No. 109–307, at 209 (2005). The Senate Committee Report provides further detail on the content of the 5-year plan, directing the IRS to: “. . . undertake a comprehensive review of its current portfolio of taxpayer services and develop a 5-year plan that outlines the services it should provide to improve services for taxpayers. This plan should detail how it [IRS] plans to meet the service needs on a geographic basis (by State and major metropolitan area), including any proposals to realign existing resources to improve taxpayer access to services, and address how the plan will improve taxpayer service based on reliable data on taxpayer service needs. As part of this review, the Committee strongly urges the IRS to use innovative approaches to taxpayer services, such as virtual technology and mobile units. The IRS also should expand efforts to partner with State and local governments and private entities to improve taxpayer services. S. Rep. No. 109–109, at 134 (2005).

we know more than ever about taxpayers' needs and preferences, and their willingness to try new methods of service delivery.<sup>23</sup>

Over the last 2 years, the IRS has begun to reverse its trend in recent years of limiting the types of services and methods of delivery. I applaud the IRS for creating a Services Committee—the counterpart to the Enforcement Committee—thereby enabling the entire IRS senior leadership to consider and coordinate taxpayer service initiatives. The IRS currently is undertaking many initiatives to assist taxpayers in claiming economic stimulus payments, including keeping the IRS's walk-in sites—known as Taxpayer Assistance Centers, or TACs—open on more Saturdays during the filing season. I am also pleased that IRS management has indicated a willingness to consider reinstating Problem Solving Days and taking a geographic approach to determining which topics to designate as “out-of-scope” (e.g., the IRS should not treat farm-related questions as “out-of-scope” in TACs located in areas where there is a significant amount of farming activity). The IRS has also recently relaxed its stringent rules that generally prevented taxpayers from obtaining copies of their tax return transcripts at the TACs.<sup>24</sup>

It remains to be seen, however, whether the IRS will dedicate the resources—both in terms of personnel, dollars, and priorities—necessary to make the TAB a reality. I discuss a few of my concerns below.

#### *Sustained Funding for Taxpayer Services Is Crucial to Meeting Taxpayer Needs*

Any reduction in the IRS's taxpayer service budget presents a significant challenge to implementation of the TAB. In fact, taxpayer service funding should be increased so that, while the IRS continues to deliver its traditional services, programs developed by the TAB team are not just piloted but are instead fully implemented. For example, this filing season the IRS is piloting an approach in the TACs called “Facilitated Self Assistance.” Under this model, taxpayers who come to certain TACs for assistance may carry out designated service tasks on IRS.gov or the IRS phone system with the help of a live IRS assistor. Preliminary feedback from the 15 TACs offering Facilitated Self-Assistance has been positive. Without sufficient funding, however, the IRS will be unable to expand the pilot testing, let alone fully implement the program, no matter how successful it might be. If the financial support for taxpayer service is not sufficient, the TAB process will have been for naught—having produced many interesting ideas and important research that simply cannot be implemented or applied.

#### *Internet Services Are Important, But They Cannot Be the Only Game in Town*

Insufficient funding increases the temptation for the IRS to put all its eggs in one basket when it comes to taxpayer service—namely, self-assisted Internet services. The Internet may be adequate for taxpayers who are comfortable handling financial transactions online, but the TAB's research studies showed that a certain percentage of taxpayers, and particular types of tax issues, require personal interaction—by telephone, face-to-face, or both.

For example, we now know that nearly 25 percent of taxpayers do not have Internet access.<sup>25</sup> Additionally, more than 25 percent of taxpayers stated that they are unwilling to use the IRS website for any service activities in the future.<sup>26</sup> Among taxpayers who used IRS services between mid-2004 and mid-2006, about 45 percent of those who called the IRS and more than 75 percent of those who visited the IRS stated they would not use the IRS website. When probed further as to why they would not use the website, more than half gave a reason that suggests they could not use the website due to lack of computer equipment, Internet access or computer savvy.<sup>27</sup> Approximately 75 percent of taxpayers stated they do not feel comfortable

<sup>23</sup> See National Taxpayer Advocate 2006 Report to Congress, vol. 2 (Research Study: Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services).

<sup>24</sup> Previously the IRS required taxpayers to obtain transcripts of their accounts through the toll-free service, which would mail a transcript within seven to ten days. Taxpayers could only obtain transcripts at TACs in “emergency” situations. It was TAS's experience that the TACs almost never acknowledged an emergency situation. In fact, since that policy was in place, TAS transcript cases have increased sharply. The IRS's more flexible transcript policy should result in fewer TAS cases in this area.

<sup>25</sup> W&I Research, *Opinion Survey of Taxpayer Resources and Services*, 2006—Question 7—22.5 percent—24.6 percent.

<sup>26</sup> W&I Research, *Opinion Survey of Taxpayer Resources and Services*, 2006—Question 8—25.3 percent—27.4 percent.

<sup>27</sup> IRS Oversight Board, *2006 Service Channels Survey*, Questions 17, 19 & 20: About 50 percent (42.5 percent–57.5 percent) of taxpayers who called or visited the IRS are unwilling to use IRS.gov (i.e., 37.2 percent–52.7 percent of those who called and 60.5 percent–92.7 percent of those who visited the IRS stated they would not use the IRS Internet site). More than 23 percent of



sharing personal information via the Internet.<sup>28</sup> Approximately 12 percent of taxpayers have some type of disability,<sup>29</sup> and about 6 percent of taxpayers speak a language other than English at home.<sup>30</sup>

The IRS has an obligation to provide services through methods that will assist all taxpayers. The IRS must therefore maintain and improve its telephone and face-to-face services for as long as there is a segment of the population that needs it—which, given the complexity of the tax law and IRS procedures, will be as far into the future as I can see.

*The IRS Should Expand and Improve the Services Provided by Taxpayer Assistance Centers*

For several years I have highlighted problems with the IRS's delivery of face-to-face taxpayer services in the TACs.<sup>31</sup> In my 2007 Annual Report to Congress, I identified several problems that limit the usefulness of the TACs, including the insufficient number and staffing of TACs and the significant conditions for obtaining return preparation assistance that have the effect of deterring taxpayers from seeking service.

*The Location and Number of TACs May Not Be Adequate*

In 2001, the IRS committed to opening 118 new TACs in the following seven to 8 years.<sup>32</sup> Unfortunately, none of these new TACs was opened, and the IRS even initiated an unsuccessful effort to close 68 TACs.<sup>33</sup> The TAB concluded that TAC offices were adequately serving only 60 percent of the United States population.<sup>34</sup> In order to make better decisions about the location, number, and staffing of TACs, the IRS developed a decision tool about TAC operations. However, that tool only includes the present TAC locations. It is not clear whether the IRS will use this program to consider adding TAC locations, even though TAB research demonstrates that TAC coverage across the United States is insufficient. Thus, we recommend that the IRS conduct additional research of population segments to determine the volume, scope, and type of services that taxpayers require by geographical location, and utilize its TAC decision tool to identify the most appropriate number and placement of TACs.

*TAC Staffing and the Availability of Services Are Inadequate To Meet Taxpayer Needs*

Only 55 percent of TACs are open for 36 to 40 hours per week, and during the last 3 years, the IRS reduced TAC staffing by 9 percent, leaving most TAC offices with staffing shortages.<sup>35</sup> Although the IRS is now hiring seasonal workers to ease the staffing crunch, I believe the IRS should make a firm commitment to providing TACs with the level of staffing necessary to meet taxpayer needs.

*The IRS Should Meet its Fundamental Tax Administration Responsibility To Provide Tax Return Preparation Assistance for Low Income Taxpayers*

I am concerned that the IRS imposes too many barriers and limitations on tax preparation. I am pleased that the IRS heeded our earlier criticism and has changed its position on requiring taxpayers to visit a TAC twice in order to obtain return

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taxpayers called or visited the IRS between mid-2004 and mid-2006, which translates to roughly 32 million taxpayers (based on a filing population of slightly less than 135 million). About half of taxpayers who use IRS phone or TAC services, approximately 16 million taxpayers, are unable or unwilling to use the Internet. IRS, *2006 Filing Season Statistics*, Cumulative Through 10/27/06, Individual Income Tax Returns total receipts = 134,919,000.

<sup>28</sup> IRS Oversight Board, *2006 Service Channels Survey*, Question 11: 70.2 percent-76.2 percent do not feel comfortable sharing personal information over the Internet. Reasons include privacy concerns (33.4 percent-40.8 percent) and Internet security issues (41.9 percent-49.6 percent).

<sup>29</sup> W&I Research, *Opinion Survey of Taxpayer Resources and Services*, 2006, Question 19: 87.2 percent-88.7 percent of taxpayers do not have a disability.

<sup>30</sup> W&I Research, *Opinion Survey of Taxpayer Resources and Services*, 2006, Question 20: 5.4 percent-6.8 percent of taxpayers speak a language other than English.

<sup>31</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 162-182 (Most Serious Problem: Service at Taxpayer Assistance Centers), *see also* National Taxpayer Advocate 2006 Annual Report to Congress xi-xiv (Taxpayer Assistance Blueprint: The National Taxpayer Advocate's Perspective); National Taxpayer Advocate 2005 Annual Report to Congress 2-24 (Most Serious Problem: Trends in Taxpayer Service); National Taxpayer Advocate 2004 Annual Report to Congress 8-66 (Most Serious Problem: Customer Service in a Complex and Changing Tax Environment).

<sup>32</sup> National Taxpayer Advocate 2001 Annual Report to Congress 49.

<sup>33</sup> IRS News Release, *IRS to Create Efficiencies with Taxpayer Assistance Centers*, IR-2005-63 (June 27, 2005).

<sup>34</sup> Internal Revenue Service, *Taxpayer Assistance Blueprint: Phase 2*, at 116 (Apr. 17, 2007).

<sup>35</sup> Information obtained from IRS Wage & Investment Division (Field Assistance function) (September 2007).

preparation services—once to make the appointment and once to have the return prepared. However, the IRS continues to downplay its own role in tax preparation.

To my mind, tax preparation is a core service for the tax administrator. The tax administrator cannot look to the nonprofit sector alone to meet the needs of the millions of low income taxpayers, including many elderly taxpayers, who cannot afford to pay a return preparer. Yet the IRS continues to straddle the line—it prepares enough returns to allow it to claim it is providing the service but makes it very difficult in some cases for taxpayers to obtain assistance. For example, the IRS has declared returns involving cancellation of debt income “out of scope” both for the TACs and for volunteer preparation sites,<sup>36</sup> even though those subjects are highly likely to impact the very taxpayers who are eligible for TAC services (whether because of credit card debt forgiveness or home foreclosures). Thus, these low income taxpayers have no alternative but to pay for return preparation, something they generally cannot afford to do.

It is not just individual taxpayers who suffer from this restriction on preparation services in the TACs. Today, organizations exempt from tax under IRC § 501(c)(3) are generally required to file an e-postcard annually if their gross receipts are normally \$25,000 or less, providing the IRS with basic contact information and informing the IRS whether the organization is still a going concern.<sup>37</sup> Failure to file for 3 consecutive years will result in automatic revocation of the organization’s exempt status.<sup>38</sup>

Approximately half of exempt organizations have all-volunteer staffs and another third have fewer than 10 employees.<sup>39</sup> These smaller nonprofits frequently lack professional tax guidance and rely on their volunteers to deal with the IRS.<sup>40</sup> Yet the TACs have agreed to assist exempt organizations with filing the e-postcard on the condition that the IRS not publicize the availability of this assistance. Thus, the only way a small exempt organization will know whether the IRS will help it is if it happens to visit a TAC on its own initiative. This “we will provide you service but we won’t tell you about it” approach falls well short of the level of service the public has a right to expect from its Government.

*The IRS Should Explore Alternative Methods of Delivering Face-to-Face Services*

In 2003, the IRS committed to providing alternative methods of service to taxpayers.<sup>41</sup> Among the ideas proposed were alternative locations to brick-and-mortar TACs and mobile units specifically tailored to the needs of the communities they serve.<sup>42</sup> I support these ideas, and I strongly encourage the IRS to pursue them and to explore other service methods as well. For example, the IRS should partner with State tax agencies, or other service-oriented Government agencies such as the Social Security Administration, to provide one-stop shopping for taxpayers. Additionally, the IRS could co-locate with other agencies, both State and Federal, to offer services targeting a specific taxpaying population (e.g., co-locate with Departments of Motor Vehicles to offer excise fuel tax assistance to truck drivers).

I commend the IRS’s recent coordination of “Super Saturday” to assist taxpayers in filing economic stimulus payment returns. The IRS should replicate that approach in similar efforts targeted at other groups of taxpayers. The IRS previously sponsored “Problem Solving Days,” where taxpayers could receive assistance on any tax issue and potentially have their problems resolved with one contact. The IRS should bring back Problem Solving Days using Super Saturday as a model and aggressively market the effort to taxpayers. Other initiatives could include National Filing Days, which I recommended in my 2007 Annual Report to Congress, where taxpayers who are currently not in compliance with their tax obligations could come to the IRS and be brought into compliance.<sup>43</sup>

*The IRS Should Expand Outreach and Education in the Exempt Organization Sector*

If the IRS is to increase compliance by exempt organizations (EOs), more resources must be devoted to outreach to, and education of, these organizations. I commend the Tax Exempt and Government Entities (TE/GE) Division’s Customer Edu-

<sup>36</sup> IRS Small Business/Self-Employed Division, Response to TAS Information Request (Oct. 30, 2007).

<sup>37</sup> IRC § 6033(i); IRC § 6033(a)(3)(B); Announcement 82–88, 1982–25 I.R.B. 23.

<sup>38</sup> IRC § 6033(j).

<sup>39</sup> IRS, TE/GE Fiscal Year 2005 Strategic Assessment 3 (Feb. 2, 2005).

<sup>40</sup> *Id.*

<sup>41</sup> National Taxpayer Advocate 2003 Annual Report to Congress 149.

<sup>42</sup> *Id.*

<sup>43</sup> National Taxpayer Advocate 2007 Annual Report to Congress 257.

cation and Outreach (CE&O) office for its existing efforts to address the needs of EOs. CE&O has done much with few resources, but it cannot adequately carry out its mission without better funding. TE/GE allocated only approximately \$1.2 million or 1.4 percent of its \$85.4 million fiscal year 2007 EO budget to education and outreach.<sup>44</sup> The number of EO education and outreach full-time equivalents (FTEs) has stagnated at approximately 12 for the last three fiscal years<sup>45</sup> while the number of EOs has grown by more than 70,000 per year.<sup>46</sup> Twelve FTEs are simply not enough to carry on the important work of EO education and outreach, regardless of how cost-effective and innovative the IRS's outreach methods may be.

TE/GE has leveraged its limited EO education and outreach resources through increased use of electronic means. Electronic education and outreach is an excellent tool that should be used in conjunction with, but not supplant, face-to-face and non-electronic outreach. For example, the Charities and Non-Profits page of the IRS website contains many useful materials, but the IRS needs to proactively distribute hard copies of those materials through partners and outreach sessions rather than wait for EOs to find and view them online. Moreover, the IRS must obtain better data on EOs' access to the Internet, how EOs use the Internet, and EOs' willingness and ability to change how they use the Internet before investing further in electronic education and outreach.

IRS Daily Delinquency Penalty (DDP) abatement rates reveal that there is great potential to reduce noncompliance with more education and outreach. The IRS may assess a DDP when an EO files an information return with missing or incorrect information<sup>47</sup> but will abate the DDP if the penalized organization later supplies the missing information or corrects the error and shows reasonable cause for the mistake.<sup>48</sup> Between 2000 and 2005, the IRS abated almost 62 percent of all assessed DDPs and nearly 68 percent of all assessed DDP dollars (nearly \$857 million).<sup>49</sup> A study conducted by the IRS in 2003 found that most assessed DDPs were attributable to organizations' failure to include Schedules A and B with their returns.<sup>50</sup>

The annual cycle of DDP assessment and abatement is not good for anyone. EOs that receive DDP assessments due to curable errors must use their resources to get the IRS to abate the penalty. Alternatively, they may simply pay the penalties to avoid dealing with the IRS but are likely to be penalized again if they do not work with the IRS to find out why the penalties were assessed. The DDP assessment/abatement cycle also wastes IRS resources. When more than 60 percent of all assessed DDP penalties are abated, IRS employees are spending significant time determining whether the mistakes that gave rise to the assessments were attributable to reasonable cause.

*To Reduce the Tax Gap, the IRS Should Place More Emphasis on Combating Noncompliance in the Cash Economy*

As you know, the gross "tax gap"—the amount of tax that is not voluntarily and timely reported and paid—stood at an estimated \$345 billion in 2001 and remains a serious problem.<sup>51</sup> As a result, households that comply with their tax obligations effectively pay a "surtax" averaging about \$2,680 per year to subsidize noncompliance by others.<sup>52</sup> Where taxable payments are reported to the IRS by third parties,

<sup>44</sup> Information received from Tax Exempt/Government Entities Division (Nov. 7, 2007).

<sup>45</sup> Information received from Tax Exempt/Government Entities Division (Nov. 6, 2007); IRS, *Tax Exempt and Government Entities Business Performance Review* 21 (May 9, 2007).

<sup>46</sup> Remarks of Steven T. Miller, Commissioner, IRS Tax Exempt and Government Entities Division, before the Philanthropy Roundtable (Dec. 10, 2007).

<sup>47</sup> IRC § 6652(c)(1)(A).

<sup>48</sup> IRC § 6652(c)(4).

<sup>49</sup> IRS Enforcement Revenue Information System (ERIS) and Statistics of Income (SOI) for EO Returns, 2000–2005 DDP assessments and abatements. *See also* National Taxpayer Advocate 2006 Annual Report to Congress 491 (Legislative Recommendation: Increase the Exempt Organization Information Return Filing Threshold).

<sup>50</sup> Ogden Form 990 Study, Attachment to Memorandum for Director, Exempt Organization SE:T:EO, *EO Correspondence Review and Timeframes* (Oct. 2003).

<sup>51</sup> The gross tax gap is the amount of tax that is imposed by law for a given tax year, but not voluntarily and timely paid. The net tax gap is the portion of the gross tax gap that remains uncollected after taking into account late payments and IRS enforcement actions for a given tax year. The 2004 IRS National Research Program study estimated the 2001 gross tax gap at \$345 billion and the net tax gap at \$290 billion. IRS, *Tax Gap Map for Year 2001* (Feb. 2007), available at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf). These figures do not include unpaid tax on income from illegal activities.

<sup>52</sup> If we divide the estimated 2001 net tax gap of \$290 billion by the estimated 108,209,000 U.S. households in 2001, we see that each household was effectively assessed an average "surtax" of about \$2,680 to subsidize noncompliance. *See* U.S. Census Bureau, Population Division (data as of Mar. 2001).

taxpayers generally report well over 90 percent of their income.<sup>53</sup> By contrast, where taxable payments are not reported to the IRS by third parties, reporting compliance drops below 50 percent.<sup>54</sup> Therefore, it should come as no surprise that underreported income from the “cash economy”—which, for tax administration purposes, we define as taxable income from legal activities that is not subject to information reporting or withholding—is probably the single largest component of the tax gap, likely accounting for over \$100 billion per year.<sup>55</sup>

Noncompliance in the cash economy merits special attention because the IRS’s traditional enforcement tools such as document matching and audits are less effective when there is no third-party reporting, and also because it is growing. According to one study, the percentage of all income subject to third-party information reporting fell from 91.3 percent in 1980 to 81.6 percent in 2000.<sup>56</sup> The IRS’s filing projections suggest that the cash economy and the amount of unreported income may continue to grow.<sup>57</sup>

*The IRS Should Establish a Cash Economy Program Office To Increase the Effectiveness of its Efforts*

In my 2007 Annual Report to Congress, I proposed a comprehensive strategy to address the cash economy portion of the tax gap that consisted of 15 administrative recommendations and seven legislative recommendations.<sup>58</sup> As a threshold matter, I believe the IRS should establish a Cash Economy Program Office. The office would have responsibility for coordinating efforts to improve compliance in the cash economy. At present, there is no single unit or executive within the IRS with responsibility for ensuring that enforcement, research, and educational activities aimed at the cash economy are implemented in a coordinated fashion. The IRS uses a coordinated approach to address certain other issues—an example being the EITC Program Office—and I believe a program office would help the IRS address the cash economy as well. Such an office would bring accountability to the effort because it could measure its success based on the impact of IRS initiatives on compliance by cash economy participants.<sup>59</sup> Absent a strategic, coordinated approach, the IRS is less likely to make progress in reducing noncompliance in the cash economy.

*The IRS Should Research the Most Effective Use of Its Audit Resources*

In addressing the cash economy, the IRS should also leverage its limited audit resources by investing in research to identify the most effective uses of these resources after taking into account the direct and indirect effects of IRS activities on tax revenue. In addition to the direct revenue that audits generate from the taxpayer for the period(s) under audit, as discussed above, economists estimate the indirect effects or “ripple effects” of an audit on voluntary compliance by other taxpayers or by the same taxpayer in future periods provide even greater revenue

<sup>53</sup> See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts), available at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.* Underreporting makes up about 83 percent of the tax gap (\$285 billion of the \$345 billion gap). Underreporting of business income by individuals—from sole proprietors, rents and royalties, and pass-through entities—accounted for about \$109 billion. Associated underreporting of self-employment taxes by unincorporated businesses accounts for another \$39 billion. *Id.*

<sup>56</sup> Kim Bloomquist, *Trends as Changes in Variance: The Case of Tax Noncompliance*, presented at the 2003 IRS Research Conference (June 2003) (citing growth in capital gains, partnership, and small business income).

<sup>57</sup> The IRS expects the number of individual returns from small business or self-employed taxpayers to grow by about 33 percent between 2006 and 2014, while the number of individual returns from other taxpayers is expected to decline by about 2 percent over the same period. IRS Office of Research, Research, Analysis and Statistics, Document 6292, *Fiscal Year Return Projections for the United States, 2007–2014* (Sept. 2007), available at <http://www.irs.gov/pub/irs-soi/d6292.pdf>.

<sup>58</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 35–65 (Most Serious Problem: The Cash Economy), 490–502 (Legislative Recommendation: Measures to Address Noncompliance in the Cash Economy), and vol. 2, at 1–43 (Research Study: A Comprehensive Strategy for Addressing the Cash Economy).

<sup>59</sup> The Treasury Inspector General for Tax Administration and the Government Accountability Office both generally agree that measures that promote accountability would help the IRS reduce the tax gap. See, e.g., Government Accountability Office, GAO-06-208T, *Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance* (Oct. 26, 2005); Written Statement of Russell George, Treasury Inspector General for Tax Administration, *Hearing Before the Senate Committee on Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies on the Internal Revenue Service’s Fiscal Year 2006 Budget Request* (Apr. 7, 2005).

gains.<sup>60</sup> The IRS needs more and better research on how best to use limited audit resources to improve compliance in the cash economy. For example:

- Should the IRS use more correspondence examinations or face-to-face examinations in cash economy industries? Does the answer depend on the industry?
- To achieve the greatest impact, should audits be clustered either geographically or within industries, so as to generate maximum publicity and possibly change local or industry norms, or should audits be more spread out in a dispersed pattern of “touches”?
- Do audits have an even greater “ripple” effect on compliance when coupled with outreach and education targeted at unaudited members of the same community?

My other recommendations fall into four broad categories: (1) making compliance easier, (2) increasing income visibility and the productivity of audits, (3) increasing the focus on preparers, and (4) identifying areas where additional research is needed to help the IRS understand how it can efficiently improve voluntary compliance.<sup>61</sup>

*The Private Debt Collection Initiative Will Cost the Federal Government at Least \$81 Million in Foregone Revenue Annually and Should Be Terminated*

In my Annual Reports to Congress and in prior testimony, I have expressed serious concerns about many aspects of the private debt collection (PDC) initiative, including the potential for violations of taxpayer rights, the fact that private collection agency (PCA) procedures are less transparent to the public—and to congressional oversight—than IRS procedures, and the evidence that the so-called “simple” cases on which the program was initially promoted do not exist in significant numbers.<sup>62</sup>

I now add to these concerns the issue of foregone revenue. Very simply, the PDC initiative will cost the Government more than \$81 million in foregone revenue this year, and the cost is likely to reach nearly a half billion dollars over the next 6 years. I explain below how I arrive at this conclusion.

The IRS projects that it will use \$7.65 million in appropriated funds in fiscal year 2008 to administer the PDC program, and it anticipates relatively steady costs in future years.<sup>63</sup> At the same time, the IRS estimates that the program will generate gross revenue averaging about \$23 million this year and next,<sup>64</sup> and it is unlikely that gross revenue will increase in future years unless the nature of the program changes significantly. By these calculations and after subtracting the direct costs of the program (\$7.65 million) and commissions payable to the PCAs (about \$4.60 million), the program can be expected to yield annual net revenue of about \$11 million. Thus, an annual IRS expenditure of \$7.65 million will produce annual net revenue of about \$11 million, which translates to about a 1.45:1 net return on investment (ROI).<sup>65</sup>

If the PDC program did not exist and the IRS instead allocated \$7.65 million in appropriated funds to its Automated Collection System (ACS) function, the ROI would be substantially higher. IRS data shows that the average ROI for the ACS program is about 20:1, which means an expenditure of \$7.65 million would generate annual revenue of \$153 million.<sup>66</sup> In testimony before the House Ways and Means

<sup>60</sup> See, e.g., Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35–36 (Oct. 1996).

<sup>61</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 35–65 (Most Serious Problem: The Cash Economy), 490–502 (Legislative Recommendation: Measures to Address Non-compliance in the Cash Economy), and vol. 2, at 1–43 (Research Study: A Comprehensive Strategy for Addressing the Cash Economy).

<sup>62</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 411–431 (Status Update: Private Debt Collection); National Taxpayer Advocate 2006 Annual Report to Congress 34–61 (Most Serious Problem: True Costs and Benefits of Private Debt Collection) and 458–462 (Legislative Recommendation: Repeal Private Debt Collection Provisions); *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means*, 110th Cong. (May 23, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>63</sup> E-mail from Director, PDC Program Office, to TAS Attorney Advisor (Feb. 29, 2008).

<sup>64</sup> *Id.*

<sup>65</sup> As discussed in the text below, the data I have cited actually overstate the likely ROI because the IRS’s cost estimates are not comprehensive (e.g., they do not include the time that Taxpayer Advocate Service case advocates spend assisting taxpayers who request our help with PDC cases or the time senior IRS executives must devote to studying, monitoring, and answering continual questions about the program) and the IRS’s revenue estimates include funds that the IRS collects on the basis of its initial letter—before the PCAs make any contact with the taxpayers.

<sup>66</sup> We have computed the full cost of an average ACS employee at slightly less than \$75,000 (assuming GS–8, step 5). The current average amount collected by an ACS employee per year

Committee last May, Acting Commissioner Kevin Brown placed the ACS ROI somewhat lower, at about 13:1.<sup>67</sup> Even accepting the lower figure, a 13:1 ROI on an expenditure of \$7.65 million would produce gross revenue of \$99.45 million and net revenue (after subtracting the \$7.65 million expenditure) of \$91.8 million.

Thus, the IRS's expenditure of \$7.65 million in appropriated funds is generating about \$11 million in net revenue when applied to the PDC program but should generate at least \$91.8 million if applied to its ACS collection function. In other words, the opportunity cost of spending \$7.65 million of appropriated funds on the PDC program each year is \$81 million, and possibly much more.

Since the purpose of private debt collection is to raise revenue, the fact that it is costing the Government \$81 million or more each year destroys whatever thin rationale might remain for its existence.

*The \$7.65 Million Cost Estimate for the PDC Program Fails to Capture Significant Costs*

In addition to consuming \$7.65 million in annual operating costs, the PDC program required \$70 million in start-up costs. The IRS previously estimated that it would recoup these "sunk" costs in fiscal year 2008 but now acknowledges that fiscal year 2010 is the earliest point at which the initiative is likely to "break even."<sup>68</sup> Moreover, as of September 2007, the IRS had 54 employees (and this total does not include Modernization & Information Technology Services (MITS) infrastructure or TAS case working employees) working on the initiative and overseeing 62 employees from the PCAs.<sup>69</sup>

The annual expenditure of \$7.65 million is significant for an initiative that is failing in most respects. Additionally, we have learned that the \$7.65 million cost estimate provided by the IRS does not include numerous expenses. The \$7.65 million cost estimate includes PDC-related costs incurred by the IRS referral unit and most IRS headquarters staff as well as costs incurred by MITS for support and by TAS to cover the cost of one employee assigned to work with the PDC Project Office. However, the \$7.65 million cost estimate does not include the PDC-related costs incurred by the IRS Office of Chief Counsel, which is periodically consulted for legal advice; the IRS Office of Legislative Affairs, which has spent considerable time presenting the program to Members and Committees of the Congress and responding to inquiries; by TAS for working with more than 1,500 taxpayers who have sought our assistance on PCA-related cases; or by other IRS functions that have helped to support the program.<sup>70</sup> We have been unable to obtain a complete estimate of the costs of the program.

*The IRS's Own Collection Actions Account for a Significant Portion of the PDC Program's Full-Paid Accounts*

Almost half—specifically, 46 percent—of the fully paid liabilities included in PDC gross revenue has been collected through offsets or direct payments made by the taxpayer after receiving a letter from the IRS informing the taxpayer that his or her account would be placed with a PCA but before the PCA made contact with the taxpayer.<sup>71</sup> These fully paid liabilities are a direct result of IRS action—not action taken by a PCA.

is about \$1.53 million. That volume of collection translates to a return-on investment on the average ACS employee of about 20:1.

<sup>67</sup> *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means*, 110th Cong. (May 23, 2007) (testimony of Kevin M. Brown, Acting Commissioner of Internal Revenue).

<sup>68</sup> *The 2008 Filing Season: Hearing Before the H. Comm. on Ways and Means*, 110th Cong. (Mar. 13, 2008) (testimony of Linda E. Stiff, Acting Commissioner of Internal Revenue).

<sup>69</sup> IRS Response to Information Request on PDC Initiative (Sept. 2007).

<sup>70</sup> IRS Response to TAS Request for Information (April 10, 2008).

<sup>71</sup> The 46 percent of fully paid liabilities includes payments received by the IRS through the following means: (a) dollars received by the government 10 calendar days or less after the IRS transferred the account to the contractor; (b) unidentified payments (*i.e.*, payments that cannot be matched and posted to a debtor's account within the contractor's inventory of accounts); (c) dollars collected in excess of an individual's balance, resulting in overpayment by the debtor; (d) dollars received on any account 11 calendar days or more after the account was returned to the IRS except as specifically described by contract; and (e) dollars received through Federal, State or local administrative, tax refund, salary, Treasury offset, Federal Levy payment or other type of offset or other administrative action which results in the reduction or elimination of the debt in a manner beyond the scope of the contractor's performance. IRS, Request for Quotation, Request No. TIRNO-05-Q-00187, at 22 (¶A.4.1). The National Taxpayer Advocate's 2006 Annual Report to Congress reported that, while the IRS would not send accounts to private collectors that were already subject to levy under the Federal Payment Levy Program (FPLP), the IRS would not recall accounts already assigned to a PCA if the account becomes subject to an FPLP levy after assignment. National Taxpayer Advocate 2006 Annual Report to Congress 43. When the IRS first described its vision of the PDC program to Congress, the IRS maintained

Moreover, more than half of the payments received by the PDC initiative are fully paid liabilities.<sup>72</sup> In many of these cases, the IRS had taken no action on the accounts after its standard “notice stream” had run its course. However, these data seem to indicate that if the IRS were to spend 41 cents on a letter to taxpayers sometime after the end of the standard notice stream to say, in effect, “Hello, we’re back,” the IRS could obtain a meaningful return.

*The Inventory of “Easy” Cases for PCAs To Work Has Largely Dried Up*

The PDC initiative has taken several steps to address the lower than expected revenue, which are deviations from the original intent of the initiative.<sup>73</sup> Because the number of “easy” cases was also smaller than expected, the IRS began to include older inventory which is more difficult to resolve.<sup>74</sup> The IRS is still searching for other types of cases to hand over to the PCAs, many of which are complex, require discretion, and are already being worked by the IRS’s own collection function. For example, the IRS is studying the feasibility of assigning cases in which the taxpayer has not agreed to the entire outstanding tax liability.<sup>75</sup> The IRS is also considering placing with the PCAs cases that ACS is currently working, and it is studying 1,500 modules to identify cases that it can move from actual IRS ACS inventory to the PCAs.<sup>76</sup> Thus, the IRS is now proposing to give the PCAs the types of cases that the IRS itself is already working and could continue to work at a greater rate in the future. Placing these types of cases with the PCAs is precisely the opposite of the premise on which the program was sold—namely, giving PCAs only the easy cases the IRS itself otherwise would not work.<sup>77</sup>

*The IRS Has Left Cases in the Control of PCAs for Much Longer Than It Originally Intended*

The IRS’s concern about the PDC initiative’s low revenue might have influenced the IRS decision to extend the timeframe for which unresolved cases from the initial stage of the PDC program (known as Release 1.1) will remain with the PCAs.<sup>78</sup> Initially, the IRS planned to recall taxpayer accounts after 12 months.<sup>79</sup> However, the IRS extended the recall to 18 months and now has extended it until the collection curve on these cases declines, but it is not clear how significant the decline must be for the recall to begin.<sup>80</sup> Nor is it clear how frequently the PCAs attempt to collect on these cases or whether the taxpayers would be better off if their cases were sent back to the IRS.

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that cases under enforcement action were not the types of cases that would be referred to private collectors. *Private Debt Collection: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 108th Cong. (May 13, 2003) (testimony of Commissioner Mark W. Everson). As a consequence of the IRS’s decision to leave FPLP cases with private collectors, private collectors are contacting taxpayers whose Social Security payments are already under active FPLP levies and are demanding full payment of the tax liability.

<sup>72</sup> IRS, *Filing Payment Compliance Advisory Council* (April 14, 2008) at 3.

<sup>73</sup> Former Commissioner Mark Everson testified: “Private collectors will work the easy cases, thereby ensuring that they will not engage in ‘inherently governmental’ activities and that the IRS will be able to focus on more complex work.” *Private Debt Collection: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 108th Cong. (May 13, 2003) (statement of Commissioner Mark W. Everson). I also testified to that point: “The IRS has stated that it will only send to PCAs those cases that meet the following criteria: (1) the taxpayer has either agreed to the tax debt and/or has made three or more payments toward that debt; and (2) the taxpayer appears to have the ability to pay this debt in full immediately or within 36 months. It is vital to the success of this proposal that only those cases that fit these parameters are selected and referred to the PCAs.” *IRS Use of Private Debt Collection Agencies by the IRS: Hearing Before the Subcomm. on Oversight of the H. Comm. Ways and Means*, 108th Cong. (May 13, 2003) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>74</sup> The IRS had to remove 15,500 cases from the initial inventory of 42,800 cases that would possibly have been assigned to private collectors. These cases were removed because the taxpayer had previous shelved delinquencies. IRS, *Filing & Payment Compliance Advisory Council Presentation 9* (July 31, 2006).

<sup>75</sup> IRS, *Filing and Payment Compliance Advisory Council* (Jan. 14, 2008) at 7.

<sup>76</sup> IRS, *Filing and Payment Compliance Advisory Council* (Feb. 11, 2008) at 10.

<sup>77</sup> *Private Debt Collection: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 108th Cong. (May 13, 2003) (testimony of Commissioner Mark W. Everson).

<sup>78</sup> IRS, *Filing and Payment Compliance Advisory Council* (Mar. 10, 2008) at 12.

<sup>79</sup> IRS, Request for Quotation, Request No. TIRNO-05-Q-00187, at 22 (¶A.4.5). Taxpayer accounts will be automatically recalled after 12 months unless the account condition warrants continued work efforts by the Contractor assigned the case. Conditions that would warrant an extension of the placement period may include acceptable payment within 60 calendar days prior to recall date or approval from the Contracting Officer’s Technical Representative (COTR). The IRS can request the return of a case at any time upon notice to the PCA.

<sup>80</sup> IRS, *Filing and Payment Compliance Advisory Council* (Mar. 10, 2008) at 12.

*To Evaluate the Cost Effectiveness of the PDC Program, an "Apples-to-Apples" Comparison Between IRS Employees and PCA Employees Is Needed*

As I have recommended in my reports to Congress, to determine the true efficiency and effectiveness of PCAs to the IRS collection function, I believe the IRS should design and implement a true apples-to-apples comparison of IRS and PCA collection.<sup>81</sup> The version of the IRS fiscal year 2008 funding bill reported by this Committee last year directed the IRS to conduct a test to make such a comparison.<sup>82</sup> Although this mandate was not contained in the final funding legislation, the IRS has taken steps toward implementing an apples-to-apples test. In January of 2008, the IRS created a team, which included TAS, to design such a test. The test would use IRS employees with similar skill sets as the PCA employees and limit IRS enforcement powers so their authority to take action on a case would mirror that of the PCAs, thereby creating an apples-to-apples comparison. In addition, it would create an entry-level bridge position for IRS employees who would like to obtain collection experience. These employees could work these easy cases that only require a phone call or could help locate taxpayers. This would be an opportunity for the IRS to train new collection employees and address the IRS's challenge to fill behind an aging workforce. Now that the test has been designed, it is time to put it into action so the IRS can honestly evaluate who can do this work better.

*The IRS Should Reassess Its Approach to e-filing to Ensure That the Needs of All Taxpayers Are Addressed and that All Taxpayers May Prepare Their Returns and File Directly with the IRS Without Charge*

While the IRS has made impressive progress in increasing the rate of electronic filing, it is still far from reaching the congressionally mandated goal of 80 percent.<sup>83</sup> During the 2007 filing season, almost 57 percent of all individual returns were filed electronically.<sup>84</sup> As the tax administrator, the IRS has the authority to determine the policies and criteria that entities must meet to participate in the e-file program. In important respects, however, it appears that the IRS has historically relinquished control of the electronic filing program to private industry and faces difficulty in re-asserting ownership of the program. Considering the significant benefits e-filing affords to both the IRS and taxpayers, we are pleased that the IRS is currently evaluating its role in the e-file program in order to increase the rate of e-file and to properly align its policies and procedures to meet the best interests of taxpayers and the agency itself. We encourage the IRS to consult with the Office of the Taxpayer Advocate on this important matter, and we look forward to lending support in any manner possible.

The IRS has an incentive to increase the rate of electronic filing to the highest level possible. Electronic filing of tax returns brings benefits to both taxpayers and the IRS.<sup>85</sup> From a taxpayer perspective, e-filing improves accuracy by eliminating the risk of IRS transcription errors, pre-screens returns to ensure that certain common errors are fixed before returns are accepted, and speeds the delivery of refunds. From an IRS perspective, e-filing eliminates the need for data transcribers to input return data manually (which permits the IRS to shift resources to other areas), allows the IRS to capture return data electronically, and enables the IRS to process and review returns more quickly.<sup>86</sup>

Nearly one-third of all individual returns processed by the IRS through October 2007—or 43 million returns—were prepared using software yet mailed rather than submitted electronically.<sup>87</sup> These taxpayers could have e-filed their returns once they were prepared using computer software, but for some reason, the taxpayers chose to file paper returns. If the IRS successfully converts a significant portion of these taxpayers to electronic filing, it would approach, and perhaps surpass, the 80 percent e-filing goal.

<sup>81</sup>See National Taxpayer Advocate 2007 Annual Report to Congress 416–418, and National Taxpayer Advocate 2006 Annual Report to Congress 34–61.

<sup>82</sup>Financial Services and General Government Appropriations Act, 2008, H.R. 2829, 110th Cong. § 113 (as reported by S. Comm. on Appropriations, July 13, 2007).

<sup>83</sup>The IRS Restructuring and Reform Act of 1998 directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007. See Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105–206, § 2001(a)(2), 112 Stat. 685 (1998). The 80 percent e-filing goal was not achieved by 2007. However, we believe Congress should reiterate its commitment to requiring the IRS increase the e-filing rate as quickly as possible.

<sup>84</sup>IRS News Release, IRS E-File Opens for 2008 Filing Season for Most Taxpayers, IR–2008–5 (Jan. 10, 2008).

<sup>85</sup>See S. Rep. No. 105–174, at 39–40 (1998).

<sup>86</sup>See IRS Fact Sheet, *2008 IRS E-File*, FS–2008–4 (Jan. 2008).

<sup>87</sup>IRS Tax Year 2006 Taxpayer Usage Study (through Oct. 26, 2007).



I have advocated for years for the IRS to place a basic, fill-in template on its website to permit taxpayers to self-prepare their tax returns and file directly with the IRS for free.<sup>88</sup> There is no reason why taxpayers should be required to pay transaction fees to file their returns electronically. A free template and direct filing portal would address some taxpayers' cost and security concerns and would result in a greater number of e-filed tax returns. For those taxpayers who are comfortable preparing their returns without assistance, the Government should provide the means for them to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they would remain free to purchase one.

During a visit to the Australian Taxation Office (ATO) last month, I had the opportunity to learn first-hand about Australia's e-file program. The ATO built e-tax, a direct filing program, completely in-house and officially launched the program in 1999. The resulting e-file (e-tax) rates are impressive.<sup>89</sup> For the 2005–2006 tax period, approximately 49 percent of all individuals who self-prepared filed their returns through e-tax, while only 7.5 percent of U.S. taxpayers who self-prepared their returns used Free File for tax year 2006 (and only 2.9 percent of all individual income tax returns filed in tax year 2006 were prepared using Free File).<sup>90</sup> Further, only tax agents (the Australian equivalent to tax return preparers) use commercial software to prepare and file returns.<sup>91</sup> It is our understanding that the IRS is currently evaluating the Australian taxation system. We hope the IRS can apply lessons learned from Australia's experience to our own e-file program, especially with regard to ATO's direct filing program, e-tax.

Recent, highly publicized phishing schemes confirm the need for the IRS to develop a free fill-in template and direct filing portal. During the 2007 filing season, for example, an Internet tax scam lured taxpayers into entering confidential tax return information on sites masquerading as Free File sites, and these taxpayers became victims of identity theft.<sup>92</sup> It is understandable that some potential Free File users fall victim to scams, especially when taxpayers wishing to prepare their returns pursuant to an IRS sanctioned program visit the official IRS website only to be directed to one of 19 potentially unfamiliar commercial websites. All taxpayers should have the option to prepare and file their Federal income tax returns on the IRS's own website.<sup>93</sup> Although Free File is accessible through the official IRS website, not all taxpayers are eligible to use the program. Approximately 30 percent of individual taxpayers—which amounts to more than 40 million taxpayers—are in-

<sup>88</sup> See, e.g., National Taxpayer Advocate 2004 Annual Report to Congress 471–477. We have proposed that the IRS create an electronic tax return that is analogous to the paper environment, but that also incorporates the benefits of electronic technology. Specifically, the return should be fill-in, with math checking and number-transfer capability. The fill-in return should link to line-by-line IRS instructions for each form, and where the IRS instructions reference a publication, there should be active links to specific sections of the forms. Where the instructions or publications have worksheets embedded in them, these worksheets should be fill-in, with math-checking and number-transfer capability. These capabilities are important, since they will substantially reduce the number of “math error” notices the IRS must issue each year.

<sup>89</sup> Unlike Free File, e-tax is available to taxpayers at all income levels. For information on e-tax, see <http://www.ato.gov.au/corporate/content.asp?doc=/content/83847.htm&pc=001/001/001/005&mnu=&mfp=&st=&cy=1> (last visited April 7, 2008).

<sup>90</sup> Australian Taxation Office, Taxation Statistics 2005–06, available at [http://www.ato.gov.au/content/downloads/00117625\\_2006CH2PER.pdf](http://www.ato.gov.au/content/downloads/00117625_2006CH2PER.pdf) (last visited April 7, 2008); E-Gov, IRS Free File Performance Measures—Summary View, available at <http://www.whitehouse.gov/omb/egov/c-7-3-irs.html> (last visited April 7, 2008). Specifically, 1,521,780 individual self-preparers filed through Australia's e-tax program in tax year 2005/2006 out of a total of 3,132,230 self-preparers. The remaining 8,378,729 individual taxpayers used tax agents (return preparers). In the United States, 3.9 million individual taxpayers self-prepared for tax year 2006 on Free File out of 49 million total self-preparers. Approximately 135 million U.S. individual returns were filed for tax year 2006. IRS Document 6149, *Calendar Year Return Projections by State, CY 2007–2014* (Rev. 12.2007), Table 1.

<sup>91</sup> Tax agents are regulated by the statutorily created Tax Agent Boards located in every state. For more information on the relationship between tax agents and tax administration in Australia, see <http://www.ato.gov.au/corporate/content.asp?doc=/content/66215.htm> (last visited March 27, 2008).

<sup>92</sup> See IRS News Release, *Late Tax Scam Discovered; Free File Users Reminded to Use IRS.gov*, IR–2007–87 (April 13, 2007). The IRS is also aware of several phishing schemes during the 2008 filing season. See IRS News Release, *IRS Warns of New E-Mail and Telephone Scams Using the IRS Name; Advance Payment Scams Starting*, IR–2008–11 (Jan. 30, 2008).

<sup>93</sup> Congress contemplated the IRS developing a basic electronic template in the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105–206, 112 Stat. 685 (1998). The RRA 98 conference report states that “the conferees also intend that the IRS should continue to offer and improve its Telefile program and make available a comparable program on the Internet.” H.R. Rep. No. 105–599, at 235 (1998) (Conf. Rep.).

eligible for IRS Free File.<sup>94</sup> Moreover, the IRS exerts little control over the content of each Free File program. As a consequence, each of the programs has its own eligibility requirements, capabilities and limitations, and the complexity is confusing to taxpayers.

Despite the IRS's best efforts, some paper filers will refuse to convert to e-file. For those cases, the IRS should develop 2-D bar code technology, which would provide taxpayers and the IRS with many of the same benefits as electronic filing.<sup>95</sup> It is my understanding that the IRS has already incorporated this technology into other functions.

Pursuant to an Appropriations directive, the IRS Office of Electronic Tax Administration and Refundable Credits (ETA) is developing a comprehensive strategic plan to meet the 80 percent e-file goal.<sup>96</sup> ETA has commissioned MITRE to conduct the Advancing E-File Study, and we are pleased that the study will determine or review the following items:

- The characteristics of paper and e-filers as well as potential barriers to e-file;
- The current third-party model of tax administration and current trends in State and foreign governments; and
- Potential strategies to increase the rate of e-file or any other means to receive return information electronically. This will entail a review of direct filing with the IRS, 2-D bar coding, and Telefile.<sup>97</sup>

I believe this study represents an important first step in the Government's fulfilling its core responsibility to taxpayers in a secure and straightforward fashion, without competing with the private sector. The Appropriations directive states that this strategic plan should be developed in consultation with me and other stakeholders, and I look forward to continuing to work with the IRS on this study.

Finally, I believe that the IRS should take a more proactive role in the electronic filing arena by setting the policies and standards for participation in the IRS e-file program. Such policies and procedures should align with the needs of both taxpayers and tax administration. All high quality return preparation and filing products should have equal access to the market, reflect the latest tax law changes, and be compatible with filing season peaks in demand as well as IRS's computer and processing needs. Moreover, all programs should meet IRS established minimum standards for data and identity security, and these standards should apply to both for-profit and free tax preparation offerings.<sup>98</sup> Unless the IRS takes corrective action, the IRS remains in a reactive position at the whim of private industry and is forced to devote scarce resources to address the downstream consequences of potentially avoidable problems. We are encouraged that the IRS is currently evaluating its role in the e-file program as part of the Advancing E-File Study and look forward to lending support to the study as well as to receiving periodic briefings of research findings as the study progresses.

<sup>94</sup> Taxpayers must have adjusted gross income of \$54,000 or less to be eligible. See IRS Fact Sheet, *2008 IRS E-File*, FS-2008-4 (Jan. 2008); Free Online Electronic Tax Filing Agreement Amendment (2005), available at [http://www.irs.gov/pub/irs-efile/free\\_file\\_agreement.pdf](http://www.irs.gov/pub/irs-efile/free_file_agreement.pdf) (last visited on April 7, 2008). Ironically, some members of the Free File Alliance provided free services to 100 percent of taxpayers under the initial term of the Free File Agreement and wanted to continue to do so, but the Treasury Department agreed with the Free File Alliance to place a cap on the number of taxpayers who would qualify for free tax preparation and filing services. As a consequence, Free File members are now *restricted* in the number of taxpayers to whom they may offer their services.

<sup>95</sup> To utilize 2-D bar code technology, a taxpayer or preparer uses software to complete the return. Once printed, the return has a horizontal and vertical bar code containing tax return information. The IRS scans the return, captures the data, decodes it, and processes the return as if it had been sent electronically.

<sup>96</sup> Staff of H. Comm. on Appropriations, 110th Cong., H.R. 2764, Consolidated Appropriations Act, 2008, Pub. L. 110-161, Explanatory Statement at 871 (Comm. Print 2007); Staff of H. Comm. on Appropriations, 110th Cong., Financial Services and Government Appropriations Bill, 2008, at 28 (Comm. Print July 2007). Although the deadline for submission of the study was March 1, 2008, the IRS Office of Electronic Tax Administration and Refundable Credits has faced considerable challenges during the current filing season, and it is planning to complete the study later this year.

<sup>97</sup> Information Provided by Electronic Tax Administration (Jan. 30, 2008); Diane Freda, *IRS to Study Direct Filing Portal, 2-D Bar Coding to Boost E-Filing*, BNA Daily Tax Report (Jan. 29, 2008); MITRE IRS FFRDC, Center for Enterprise Modernization, IRS Advancing E-File Study: Draft Overview of Findings to Date (Jan. 31, 2008) (on file with the Office of the Taxpayer Advocate).

<sup>98</sup> At the time of this writing, it is not clear how many of the programs listed on the IRS e-file partner webpage would meet IRS-developed data or identity security specifications.

*Taxpayer Advocate Service Case Receipts Have Risen by 47 Percent Since Fiscal Year 2004 While the Number of Case Advocates Available To Work Taxpayer Cases Has Declined by 13 Percent*

I will close with a brief report on my own organization, the Taxpayer Advocate Service (TAS), and its role in identifying and mitigating the downstream consequences of IRS actions and programs, and improving taxpayers' attitudes toward the tax system. Since I became the National Taxpayer Advocate in 2001, I am pleased to say that TAS has grown up as an organization and substantially improved its ability to assist taxpayers. In fiscal year 2001, our quality measures showed a performance level of 71.6 percent. In fiscal year 2007, TAS's talented and dedicated employees managed to achieve a quality rating of 90.5 percent. The performance of TAS employees since fiscal year 2004 has been particularly commendable—TAS case receipts rose an overwhelming 47 percent from fiscal year 2004 to fiscal year 2007,<sup>99</sup> while the number of case advocates available to work those cases declined by 13 percent over the same period. Yet we have managed to handle this increased workload while maintaining consistent case quality over these 3 years.

The increase in TAS cases is not surprising. The IRS has substantially increased the number of its compliance actions in recent years,<sup>100</sup> and about 65 percent of TAS's cases are classified as "compliance" related.<sup>101</sup> Increasing the number of compliance cases inevitably produces a corresponding increase in TAS cases. Thus, the greater IRS emphasis on enforcement has resulted in a greater need for TAS services. Economic downturns also contribute to increases in TAS inventory, as taxpayers who lose their jobs and become unable to pay their tax bills get into trouble with the IRS and seek assistance.<sup>102</sup>

TAS is able to assist most taxpayers who seek our help. Overall, TAS was able to obtain full relief for the taxpayer in 69 percent of the cases we closed in fiscal year 2007 and partial relief in an additional 4 percent of our cases.

TAS Customer Satisfaction surveys provide some evidence that the quality and nature of taxpayer service has an impact on taxpayer attitudes toward the tax system. When a taxpayer brings an eligible case to TAS, he is assigned a case advocate who works with him throughout the pendency of the case. Taxpayers have a toll-free number direct to that case advocate, and each TAS office has a toll-free fax number. TAS employees are required to spot and address all related issues and to educate the taxpayer about how to avoid the problem from occurring again, if possible. This level and quality of service drives TAS's high taxpayer satisfaction scores, as evidenced by the results for the last 2 years. In fiscal year 2006 and fiscal year 2007, the percentage score for overall satisfaction of the taxpayers who came to TAS was 85 percent and 83 percent, respectively. Equally important, 50 percent of taxpayers stated that they felt better about the IRS as a whole after coming to TAS. Even among taxpayers who did not obtain the result they sought, an impressive 34 percent reported that they had a more positive opinion of the IRS because of their experience with TAS.<sup>103</sup>

However, I am concerned that with the increasing volume, complexity, and urgency of TAS's caseload, the cycle time for our cases has begun to increase. Closed case cycle time was 71.1 days in fiscal year 2004 but has risen to 80.6 days in fiscal year 2008.<sup>104</sup> These results are hardly surprising. If you increase the workload of a customer service organization by 47 percent and reduce the number of employees available to assist customers by 13 percent, you are essentially increasing the average workload of each employee by nearly 70 percent. And because TAS generally assists taxpayers only where they face an imminent economic burden because of an

<sup>99</sup> In fiscal year 2007, TAS received a total of 247,839 cases. In fiscal year 2004, TAS received a total of 168,856 cases.

<sup>100</sup> On the Examination side, the number of individual return closures increased by 37 percent and the number of business return closures increased by 102 percent from fiscal year 2004 to fiscal year 2007. On the Collection side, the number of levies increased by 85 percent, the number of liens increased by 28 percent, and the number of seizures increased by 54 percent over the same period. See Internal Revenue Service, fiscal year 2007 Enforcement and Services Results (Jan. 17, 2008) (accompanying fiscal year 2007 Enforcement and Services Tables), available at [http://www.irs.gov/pub/irs-news/irs\\_enforcement\\_and\\_service\\_tables\\_fy\\_2007.pdf](http://www.irs.gov/pub/irs-news/irs_enforcement_and_service_tables_fy_2007.pdf).

<sup>101</sup> In fiscal year 2007, TAS classified 160,131 case receipts as compliance-related and 87,708 as service-related, for a total of 247,839 case receipts.

<sup>102</sup> TAS received 86,261 economic burden case receipts in fiscal year 2007 compared with 34,653 in fiscal year 2004—a 149 percent increase.

<sup>103</sup> For fiscal year 2006, the Gallup Organization collected the customer satisfaction data for the Taxpayer Advocate Service. In fiscal year 2007, TAS began using a new vendor, Macro International, to conduct its surveys.

<sup>104</sup> Fiscal Year 2008 data reflects case closures from October 1, 2007 through March 31, 2008 (six months).

IRS collection action or where normal IRS procedures have failed, TAS does not have much flexibility to turn away cases. Indeed, TAS expects to receive more than 250,000 cases in fiscal year 2008, and our case inventory continues to rise. If the balance between TAS staffing and the number of cases we handle does not improve, I am concerned that TAS is in jeopardy of becoming part of the IRS problem rather than the advocate for the solution, as Congress intended.

Lastly, I provide a brief report on the Low Income Taxpayer Clinic (LITC) program, which is administered by my office. For fiscal year 2008, the IRS's Taxpayer Services appropriation included \$9 million for LITC grants. This appropriation represented an increase of \$1 million compared with the 2007 grant cycle.<sup>105</sup> The LITC program currently funds 154 clinics in all 50 States, the District of Columbia, Puerto Rico, and Guam, thus meeting my goal of having at least one LITC in each State. The increased appropriation allows us to provide funding for new clinics as well as to provide increased funding for existing clinics that have expanded or plan to expand their services to underserved areas and populations. This additional funding also has enabled the LITC Program to work toward its goal of funding at least one controversy and at least one English as a Second Language (ESL) clinic in every State. The LITC Program Office, in conjunction with TAS Research, has identified locations where there are significant populations of low income and ESL taxpayers who are not currently served by a clinic. Recently, we announced a supplemental grant period to solicit qualified organizations willing to address the needs of these identified areas.<sup>106</sup>

#### *Conclusion*

Compared to the IRS of 10 years ago, the IRS of today is a more responsive and effective organization. On the customer service side, the IRS Restructuring and Reform Act of 1998 and the IRS response have brought about fairly dramatic improvements, and the Taxpayer Assistance Blueprint, created in response to an Appropriations directive, provides a useful roadmap to maintain and improve the delivery of taxpayer services. On the enforcement side, the IRS has been ramping up its enforcement of the tax laws, particularly with regard to corporate tax shelters and high-income individuals, and the results have generally been positive.

But the IRS can, and should, do better. To increase voluntary compliance, the IRS should incorporate an ongoing taxpayer-centric assessment of taxpayer service needs into its strategic plans. It should consider whether it can meet taxpayer service needs adequately when it devotes only 6 percent of its budget to taxpayer assistance and education. It should conduct research (including applied research) into the causes of noncompliance and apply the resulting knowledge to IRS enforcement strategies, including those pertaining to the cash economy. Finally, the IRS must have sufficient resources to move forward with its technological improvements, which are critical to its ability to improve both its Taxpayer Services and Enforcement functions.

#### PRIVATE DEBT COLLECTION

Senator DURBIN. What a loser this private debt collection is. I mean, it just seems like we are stuck on this. Not to say anything negative about our colleagues, but my guess is that it is just a nice, little business with a bunch of employees in several places in America that the Senator and Congressmen want to keep open, but it sounds like it is a bad deal. This is privatization that is costing us more than if we used the public employee. Is that your conclusion?

Ms. OLSON. Well, I think that it originated in a concern that there was a pool of taxpayers that the IRS was not currently touching and that we were not going to get additional appropriations to hire employees to touch those taxpayers. And what has turned out is that, first, that pool of cases, the ones that are easy to work, do not exist. We are running out of those cases and we are reaching

<sup>105</sup> Although appropriations are made on a fiscal-year basis, grants for the LITC program are awarded on a calendar-year basis (which we refer to as the "grant cycle").

<sup>106</sup> Low Income Taxpayer Clinic Grant Program; Availability of 2008 Supplemental Grant Application Period, 73 Fed. Reg. 15,841–42 (Mar. 25, 2008).

into cases that the IRS is actually scheduled to work, and we are stretching the bounds of what PCAs can do efficiently.

The second thing we have found is what I highlighted in my testimony, that a lot of these cases, if the IRS sent a letter—we get a return that a lot of these cases have just been sitting there——

Senator DURBIN. You said 46 percent.

Ms. OLSON. For a 41-cent stamp, we would get the taxpayer going, oh, they are back on the scene. We need to respond to them instead of our other creditors.

Senator DURBIN. Of course, if the private debt collector gets in, they get what? Twenty-five cents on \$1?

Ms. OLSON. Well, up to 25 cents on \$1? Yes, correct.

Senator DURBIN. So that seems like a loser.

Mr. George, about this brain drain, do you know what the IRS is doing to use student loan forgiveness to either recruit or retain talented people?

Mr. GEORGE. Actually I do not, Mr. Chairman. Allow us to get back to you on that.

Senator DURBIN. Would you?

Mr. GEORGE. But if I may, though, could I briefly address the private debt collection issue?

Senator DURBIN. Sure.

Mr. GEORGE. Because TIGTA recently conducted an audit and there are a couple of facts that I would like to share with this subcommittee for your appreciation.

As of February 23 of this year, the total cases assigned to the private debt collection agencies are approximately 98,000 with the dollars assigned of just under \$900 million. The actual payments received as a result of this program are \$46.19 million. Out of this, the commissions paid to the private debt collectors has been just over \$7 million. The number of accounts paid. Again, out of approximately 98,000, the total number of accounts fully paid is just over 12,000. The number of accounts entering into installment agreements is just over 5,000, and the number of accounts referred to, as we call them, taxpayer account services is just over 1,300.

We really do not know whether or not a simple letter would achieve these results. We have not done the research to give you a definitive answer in that regard. But Senator Brownback may recall that when he was on the Government Reform Subcommittee, chaired by Congressman Stephen Horn, over 10 years ago, we worked on this very issue. Back then the program, the pilot that was established, was an abject failure. No one would disagree with that point. Here we just simply do not know whether the startup costs are those that the private sector would simply assume are a part of doing business as the startup costs.

So the bottom line is I am saying I want to make sure that this tax gap is addressed somehow and if turning to a project such as a private debt collection would help address it——

Senator DURBIN. It sounds objective and valid, but it is not working. How long have we been trying this now?

Ms. OLSON. The program started in September 2006, and in fact, the way it is structured is any payments that come in the first 10 days in response to the first letter the IRS sends to the taxpayer saying, hello, we are back, we are going to send your case out to

the private debt collectors if you do not respond to us, are non-commissionable payments. And we do have those numbers. In 2007, out of the \$32 million—is that how much we collected? And \$31 million in 2007. About \$5 million came in the first 10 days.

So you can see it is about 19 percent of the collections were in response to the IRS letter, and I maintain that if we sent a letter saying, hello, we are back and we could levy on your bank account, on your pay stub, all the things that we could do, we would get a response.

Senator DURBIN. I am going to go over time here.

Senator BROWNBAC. I will not tax you.

Senator DURBIN. Thanks. No penalties, no interest.

#### BUSINESS SYSTEMS MODERNIZATION

Mr. Cherecwich, my experience has been that the Federal Government is not very darned good when it comes to business modernization systems. And I have some personal experience since 9/11 trying to get the FBI to have an updated computer system. I cannot tell you how much money we have wasted in that effort and still are not where we ought to be.

There are similar efforts that have been made in trying to verify visas coming in and out of this country. For more than 10 years, we have failed to come up with what appears to be a pretty simple task.

So what kind of confidence do you have if more money is funneled into the IRS for business modernization systems and technology that it is going to be well spent?

Mr. CHERECWICH. A couple of responses to that, Senator. Typically with high-tech projects, you have a little bit of risk going into them, and delays and failure to meet schedules are to be expected. Any business that tries to install a massive computer system like we are talking about, a massive information system, will expect to have hiccups along the road. What happens in business when you get a hiccup along the road is not that you cut the funding because they are bad boys. You turn around and you provide the support in the manner in which you feel that they can deal with that.

Now, how do I feel comfortable that they can deal with that? The IRS in the last few years has developed something they call a modernization and visions strategy for their computer systems, their information structures. And this modernization and visions strategy is a tool in which projects can be prioritized and the appropriate management assigned to make them work. It is an overall program that gives me a great deal of comfort that the IRS is on a proper path to properly manage this.

Where we will run into difficulty is this ramped-down stuff where we start losing all the skilled people. We need to have good, steady, level funding and keep moving forward.

Senator DURBIN. I am going to ask my ranking member a favor here. I have to take a phone call, and if he would be kind enough to ask questions and recess the subcommittee meeting. I want to personally thank the panel and others who have been here today to help us.

Senator Brownback.

Senator BROWNBAC [presiding]. Thank you very much.

All those in favor of a flat tax?

I have got to wait until he gets out of the room.

#### TAX SIMPLIFICATION

I want to look at tax complexity. You guys are very familiar with this Code. I think the difficulties of enforcement are interesting.

I presume all of you would agree with me that if Congress provided a simpler Code, that there would be more compliance with the tax system.

Mr. CHERECWICH. It is hard to argue with that one.

Mr. GEORGE. I agree, Senator Brownback.

Senator BROWNBAC. Have you studied or looked at other countries that have simplified codes—other industrialized countries that have a similar system and know of compliance rates? Nina?

Ms. OLSON. Well, I think that some of them are—although the IRS might not like this heard—comparable to us. Some of them have divided their tax systems between a modest income tax and then a value-added tax or a goods and services tax.

I think that some of the directions talking about a return-free system, some of the systems like Sweden where they have so much information on their individuals, that they have a very high compliance rate, but they know more about their citizens—

Senator BROWNBAC. Yes. Well, our folks do not really go for that.

Ms. OLSON [continuing]. Than United States people would want.

Senator BROWNBAC. But are there other industrialized countries that have simplified systems that are not thoroughly penetrated into a person's personal information?

Ms. OLSON. I was just in Australia this past month for a tax conference, and they have a system that has income tax, has a pay as you earn essentially system, so that many people just like the United Kingdom do not have to file taxes because the taxes are paid by the employer and you pay what you pay each paycheck and you do not do a return reconciling. You only file a return when you have sole proprietorship income or capital gains, you know, transactions that the tax system would not know about. And then the rest of the tax is made up by either a goods and services or a value-added tax, which is paid along the way and is invisible to the individual taxpayer at least.

Senator BROWNBAC. What would you like to see us do to simplify the system?

Obviously, up here in Congress we use the Tax Code to try to manipulate the economy, to try to stimulate the economy, to try to get people to do certain things. And each attempt adds a layer of complexity, and we are all guilty of it. Every lobbyist in town is hired by somebody to do something in this Tax Code, and they are very good. So you have got an incredibly complex Tax Code.

But what would you like to see us do? What should we do on tax simplification?

Ms. OLSON. Well, let me hedge my comments by saying I do not do tax policy. I look at this from the taxpayer's perspective in terms of being asked to comply with the laws and the difficulty there. And so I will not go into whether it needs to be a flat tax or what kind of tax. But whatever tax system we have it has to be intuitive

to the basic taxpayer and not impose arcane rules like the alternative minimum tax that confuses people.

I think that the President's reform panel made some really interesting proposals, and I would like to see some of them revisited.

I think that, as well, we do need to look around the world and see what other industrial nations are doing and what the differences are with their population and our population. We have to keep the taxpayer's perspective in mind and say what is it that taxpayers can handle so that we do not set them up for problems.

Senator BROWNBAC. I have studied some on the flat tax systems in different countries, and the countries I have gone to are generally second world countries. But they substantially lowered their rate. They simplified their system. They increased Government revenue substantially in those places and they increased compliance. Currently, with high rates and complexity, a lot of people just said, I am out of here. I am going to figure a way around you guys, and did. But if it got down to a rate that was fairly simple, a lot more people will say, well, rather than trying to skip around this, I will pay it. That is that intuitive piece, I think, of what you are saying.

Ms. OLSON. Yes. Well, and I think also that goes to something else we have been recommending which is that IRS do more research into the reasons that taxpayers do not comply because once you learn that, you can incorporate that into not only just how do you do your outreach and your education and your enforcement initiatives, but also into your system design. If you know what causes taxpayers to not comply, whether it is attitude or the sheer complexity of the laws, they get confused, that informs how your system should look.

Senator BROWNBAC. Do we know the answer to that, Mr. George?

Mr. GEORGE. Well, I have to, at the outset, say, Senator Brownback that, as Nina indicated, tax policy is not my bailiwick and actually under directives within the Department, I am not in a position to advocate a particular policy.

That stated, there is no question that if there were a simplified tax system, more people would easily or more readily comply with their requirements. For example, I note that if the legislation that is before Congress helping to determine the cost basis of stocks were enacted, that would most definitely, I think, help in terms of the overall compliance with people acknowledging what they paid and what they owe after stock transactions. I actually had an opportunity to raise this issue with Jim Cramer of CNBC and he readily acknowledged that that would be a very helpful device and that it would not be too burdensome on the financial industry.

Senator BROWNBAC. It would seem like all you guys could help us quite a bit if, as we are proposing tax changes, which happen every year in the Congress, you had some sort of complexity index or rating of what this is going to do on making the Tax Code more complex. Our focus is the policy initiative we are trying to hit with the money we have. That is the whole game. We want to go green and we have got this pool of money. So how do we get this policy into that amount of money? But we never really look at the complexity issue of what it is going to do to the complexity of the code and its impact.



It would be a helpful exercise actually, particularly because I think right now what people are most fed up with is the complexity of the Code. I would like to see the rates lower. I think most people would like to see the rates lower. But what really drives them nuts is how complex this thing is.

Mr. CHERECWICH. Senator, our Board conducts an annual attitude survey among taxpayers, which I referred to earlier. Among the findings of that survey is most Americans think it is inappropriate to try to cheat on their taxes. They think it is appropriate to pay the taxes as required.

Given the complexity of the Tax Code, we feel that it is very important to balance the combination of services with enforcement. We have a tax gap and we cannot audit our way out of the tax gap. We have to have this balance with services and enforcement. And that is the reason why our recommended budget for fiscal year 2009 has that balance in recognition of the complexity that you talk about.

Senator BROWNBACK. I think you also note in there if it was not as complex, you would not have quite as big a tax gap. That is a feature of it as well. That is our role here in Congress, and I think we need to do a lot better on that.

Thank you all very much for being here.

#### ADDITIONAL COMMITTEE QUESTIONS

The record will remain open for a period of 1 week for people to be able to submit additional questions or for panelists to submit statements into the record.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

#### QUESTIONS SUBMITTED BY SENATOR MARY L. LANDRIEU

*Question.* Last year, I sent a letter to Acting Commissioner Stiff, suggesting several ways to alleviate some of the financial burdens on individuals who are being taxed on these grants. In Commissioner Stiff's December 27, 2007 letter to me, she responded that all but one of my suggestions required a legislative fix. The one suggestion she did not address—providing families more time to pay back any tax attributable to their grant—would have provided short term relief and would have allowed us more time to craft a legislative solution to the problem.

Why didn't Commissioner Stiff address this solution?

*Answer.* I understand that then-Acting Commissioner Stiff intended the response to indicate the mitigation you requested, extending the time to pay back tax attributable to a Road Home grant, requires legislative action. We apologize for not being clearer in this regard.

*Question.* Could the IRS have allowed for an extension of time?

*Answer.* No, there is no legal basis to extend the time period for affected taxpayers to pay the tax due. Legislation would be required in order to provide additional time to pay the tax due in this case, either by extending the payment date or providing for a payment of tax over a number of years.

*Question.* What was the basis for concluding that the IRS could not provide additional time for hurricane victims to pay back any tax attributable to a Road Home grant?

*Answer.* The IRS does not have the discretion applicable to provide taxpayers with an extension of time to pay taxes due.

*Question.* Are there other administrative steps that the IRS can implement to mitigate the effects of its decision to tax Road Home grants?

*Answer.* Because, as discussed above, our administrative flexibility is limited under the law, the IRS has focused on providing information to keep taxpayers well-informed on this issue. Representatives from the IRS met with tax professionals and

others to provide tax assistance on Road Home grant issues (among other tax issues relating to the hurricane). The IRS continues to keep an open dialogue with local tax professionals to identify and address emerging filing issues, including issues involving Louisiana Recovery Authority (LRA) Grants and the effect of the taxpayer reporting a casualty loss in a prior tax year. The IRS website has a page dedicated to providing information on disaster relief, which includes detailed responses to frequently asked questions for hurricane victims concerning the tax implications of Road Home grants, including the tax-benefit rule.

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QUESTIONS SUBMITTED BY SENATOR WAYNE ALLARD

*Question.* Can you please provide me with an accurate and detailed account outlining where the IRS audit process involving conservation easements currently stands in Colorado?

*Answer.* The status of the audit process is as follows:

- We have issued 183 private offer letters. These private letter offers are similar to settlement proposals. The letters address over 400 tax years and over 103 easements. They concern over \$38,900,000 in claimed easement donation value.
- Of the 183 offer letters, 64 (35 percent) have been accepted, 91 (50 percent) have been rejected, and 28 (15 percent) are pending.
- We expect to send a small number of additional offer letters within the next several weeks.
- Audits are continuing for 316 taxpayers, 489 tax years, and 159 easements.
- Audits have concluded for 356 taxpayers, 667 tax years, and 168 easements.

*Question.* Does the IRS have any intention of refocusing its investigation off of legitimate easements and focus solely on those who have been targeted by the state?

*Answer.* The IRS strives to avoid focusing its investigations on legitimate easements. Our efforts have focused on two approaches. First, we attempted to resolve through our settlement offer program those cases in which the sole issue was valuation of the easement. Although this approach resolved many cases, we will need to do further work with respect to those taxpayers who declined to accept the settlement offer. Second, we have been investigating some of the organizations that have been targeted by the state of Colorado as promoters of questionable or abusive easements. We intend to pursue our work with respect to these cases as we complete our work on conservation easements in Colorado and elsewhere across the United States.

*Question.* In mid-November, the IRS began making settlement offers to a significant number of conservation easement donors under audit in Colorado. According to the IRS, the settlements were only offered in those cases where the sole issue between the donor and the IRS is valuation.

The offers generally fell into a “bucket” where the IRS stated only 30 percent, 60 percent, or 75 percent of the original value of the charitable donation was allowed.

What were the criteria the IRS used to place different taxpayers into these various “buckets”? Did the IRS indicate in writing to the donor how or why the IRS arrived at their decision? If not, why?

*Answer.* The IRS established the three separate categories after reviewing factors that affected the strength of the taxpayers’ appraisals and other substantiation of the deductions claimed, with the highest allowance percentage being provided to those taxpayers the IRS believed had the strongest cases, taking into account the hazards of litigation. A 30 percent allowance offer was made to those taxpayers that had subdivided their properties into small parcels, such as 35 acre parcels, in connection with making a contribution of an easement.

The primary difference between the 60 percent and 75 percent categories was the extent of the taxpayer’s appraisal process; 75 percent was offered to those identified as having undergone an appraisal process that was identical or similar to Colorado’s “Great Outdoors Colorado” (GOCO) process; and 60 percent was offered to all other taxpayers. GOCO is a state program intended to encourage conservation and preservation, including through conservation easements.

We attached as Appendix A a copy of the standard form of letter that was sent to the taxpayers, as well as one of its attachments—a letter from the state of Colorado concerning the resolution of state income tax liability. The standard letter invites taxpayers to contact the IRS with any questions they may have. Many taxpayers who received this letter have done so, and have discussed their offers and the reasons for them with Revenue Agents and Engineers.

*Question.* Since the IRS investigations began into the 2003 easements how much money has the IRS recuperated and how much taxpayer money has been spent on the blanket audit of conservation easements in Colorado?

Answer. Our information systems do not track costs in this fashion. To date in Colorado we have assessed \$6.9 million in tax, penalties, and interest in these cases.

We respectfully note that decisions on administering the tax laws generally are not guided exclusively by a cost-benefit approach as contemplated by the question. Other considerations, including requirements of the tax law, the deterrent effect on taxpayers, and the interests of justice, must be taken into account.

*Question.* Wouldn't the IRS be more successful in recuperating tax dollars if it investigated the same fraud the state uncovered rather than auditing good easements that have been shown to meet rigorous state and national standards?

Answer. The IRS commenced this examination program because of problems reported and discovered in conservation easement donations generally, but initially focused on Colorado after the State of Colorado expressed its concerns regarding valuation and other issues involving donations made in Colorado. The State initiated its actions after our work elsewhere had begun. We have and will continue to work collaboratively with the State of Colorado and will focus on what we believe are the more egregious cases.

*Question.* How much money does the IRS expect to spend defending its settlement offers in court? Do you find this to be a good way of using taxpayer's dollars?

Answer. No reliable estimate of such costs is possible until we know better the number of cases involved. However, as we choose how to audit and resolve cases, we always take into account limited resources and long-term strategies. We experience such choices in virtually every examination initiative.

*Question.* Does the IRS have appraisers or other professionals that are experts in conservation easements? If not, why?

Answer. Yes, the IRS does have a number of appraisers and other specialists who are experts in valuing various forms of property, and who have valued conservation easements for federal income tax purposes.

*Question.* Has the IRS used the experts in conservation easement valuation or tax law that have offered their expertise? If not, why?

Answer. Yes, and we will be using more. The IRS is currently working to hire additional experts to work Colorado cases, including cases involving potentially abusive promotions of easements.

*Question.* The longer these cases remain pending, the more impact they can have on land conservation in Colorado. When does the IRS expect to conclude their investigation?

Answer. The IRS understands the need to be expeditious in attempting to resolve these cases. The IRS has already completed examination work in Colorado easement cases involving 168 easements. Cases involving 159 easements remain open at this time. The IRS continues to work toward completing its examinations involving Colorado easements, and we recently dedicated additional resources to complete them as quickly as possible. Although the IRS expects to conclude many of its examinations of the existing open Colorado conservation easement cases by December 2008, we expect that the balance of the examinations work will not be completed until as late as June 2009. This timeframe does not include the time required for cases to work their way through the Appeals and litigation processes.

#### APPENDIX A

Internal Revenue Service  
(IRS Address)

Date:

{Taxpayer name}  
{Address }

Department of the Treasury

Refer Reply to:

Group:

Person to Contact:

Employee Identification Number:

Contact Telephone Number:

Dear (Taxpayers name):

This letter is to inform you that Appeals has considered the federal tax implications of a group of returns reflecting charitable contributions of conservation easements in the state of Colorado. Because your conservation easement is within that group, the Internal Revenue Service proposes to resolve the issue(s) related to the conservation easement contribution claimed on your federal income tax return for XXXX(tax year) under Delegation Order 4-25, as described below. This proposed offer must be accepted within 30 days of the date of this letter.

This resolution reflects Appeals' assessment of the hazards of litigation. Appeals has concluded the settlement proposed in this letter is an equitable resolution of the issue(s). Absent atypical facts and circumstances, you (investor or investor partner) should not expect a resolution of the tax issue on terms that are more favorable

than the terms offered in this letter. If you do not accept this offer, the resolution of your case in Appeals will be based on the merits of the issues presented and may in fact be less favorable than the terms of this letter.

If you accept this offer, the Service will resolve your conservation easement on the following terms. For purposes of this settlement:

1. The government will treat the easement you donated during the year 20xx as a qualified conservation easement contribution.
2. The allowed amount of the conservation easement contribution is based upon the amount of the value of the easement originally claimed and the hazards of litigation. Please see the attached Form 4549A.
3. If you sold or transferred the Colorado state tax credit resulting from the donation of the conservation easement, the amount you received in exchange for the sale or transfer will be subject to tax as ordinary income. Please see the attached Form 4549A.
4. If the settlement results in an adjustment for a period(s) other than the period(s) listed in the first paragraph of this letter, you will file amended returns reflecting the settlement and furnish copies of same to the person named above.
5. You are liable for interest as provided by law.

You are not eligible for this settlement offer if the conservation easement in question involves:

1. An appraisal that determines the highest and best use for the property is the extraction of natural resources where such resources have not been shown to exist or to be economically feasible to extract.
2. A quid pro quo arrangement.
3. Property which was purchased or sold within 18 months of the contribution of the conservation easement.
4. A contribution made to a donee organization that either does not qualify under section 501(c) (3) of the Internal Revenue Code or is under active consideration for termination of its exempt status.
5. An appraisal from a participant or individual who was involved in the promotion or marketing of conservation easements or under investigation for inflated valuations.
6. Conservation land easement on property outside the state of Colorado.
7. The legal issue of whether the contribution is a qualified conservation contribution under section 170(h) of the Internal Revenue Code.

In addition, you are not eligible for this settlement offer if you are:

- A. A party to a court proceeding (individual or as a partner in a TEFRA partnership) in which the determination of the tax treatment of the conservation easement is at issue.
- B. A partner, owner, promoter, or advisor in the business of developing real estate.
- C. A promoter, partner of a promoter, or employee of a promoter of a conservation easement transaction.
- D. A person under criminal tax investigation. This includes a person under related criminal tax investigation by the Service or the Department of Justice, or a person who has been notified before the date of execution of the Form 906, closing agreement, that the Service or the Department of Justice intends to commence a tax related criminal investigation of that person.

If any of the above exclusions applies, you are not eligible for this settlement offer.

If you are eligible for this settlement offer and wish to resolve your Colorado conservation easement issue on the terms set forth above, you must sign and return the enclosed Forms 870-AD (triplicate original signatures) and Forms 906 (triplicate original signatures) to the person whose name is listed above within 30 days of the date of this letter.

You must thereafter cooperate with the Service to resolve your case expeditiously. In addition if the Service requests additional information, or documents necessary to effect this settlement, you must provide those documents within 20 calendar days of the request. The Service will grant an extension of the 20 day period only in exceptional circumstances and at its discretion.

The settlement is not binding until both you and the Service sign a specific matters closing agreement (Form 906) and Form 870-AD resolving the issues for all taxable years affected by this transaction in accordance with the above terms. When the Service signs the specific matters closing agreement, the one-year period of limitations on assessment will begin under section 6229(f) of the Internal Revenue Code for investor partners.

Full payment of the liabilities under this offer is expected by the date the closing agreement and Form 870-AD are returned to the Service. If you are unable to make full payment, you must submit complete financial statements (Form 433-A or Form 433-B, as appropriate) and return them to the person whose name is listed above.

If you choose not to accept this proposed settlement or you are not eligible for this settlement, development of the issue will continue. If the issue is still in dispute at completion of the examination, you may request an Appeals conference.

This settlement is solely a settlement of civil tax matters. No statement contained herein shall be deemed to be an admission by the Service. Nothing herein shall preclude the Service from asserting a position on the merits that is different from this settlement in contexts other than those concerning the civil tax liability of the taxpayer-parties whose cases are settled under this offer.

If you choose to have a representative you must authorize such representation by completing a Form 2848, Power of Attorney and Declaration of Representative. You can obtain this form from a local IRS office, through our website at [www.irs.gov](http://www.irs.gov) or by calling 1-800-829-3676.

Also, enclosed is a letter from the state of Colorado which provides instructions on resolving your state income tax liability involving this issue provided that you resolve your federal tax matter at this time.

If you have any questions, please contact the person whose name and telephone number appear at the top of this letter.

Sincerely,

Name of Person Issuing Letter  
Title of Person Issuing Letter

Enclosures:

Form 906  
Form 870-AD  
Form 4549A  
Form 433-A  
Form 433-B  
State of Colorado letter

STATE OF COLORADO,  
TAXPAYER SERVICE DIVISION,  
DEPARTMENT OF REVENUE,  
DENVER, COLORADO 80261, NOVEMBER 1, 2007.

#### COLORADO DEPARTMENT OF REVENUE SETTLEMENT OFFER

Taxpayers who participate in the Internal Revenue Service's conservation easement donation settlement offer will also be eligible for a settlement offer from the Colorado Department of Revenue according to the terms set forth below. The IRS will advise the Colorado Department of Revenue of the identity of taxpayers who qualify for their offer as allowed through our information sharing agreement.

In order to accept the Colorado offer, the taxpayer must file an amended return for all affected tax years within 30 days of the acceptance and execution of the IRS' settlement offer. The amended return(s) will include:

- Adjustments to federal taxable income matching the federal settlement adjustments;
- Adjustment to Colorado's federal charitable contribution deduction addback to the extent applicable to the federal settlement adjustments;
- Repayment by the easement donor of 50 percent of the gross conservation easement tax credit that would have been disallowed under the federal settlement adjustments. The donor may pay this amount rather than having the transferees assessed.

Questions regarding this offer should be referred to Richard Giardini at the Colorado Department of Revenue at 303-866-3900.

RICHARD GIARDINI,  
*Colorado Department of Revenue, Taxpayer Service Division.*

#### SUBCOMMITTEE RECESS

Senator BROWNBACK. The hearing is recessed.

[Whereupon, at 4:13 p.m., Wednesday, April 16, the subcommittee was recessed, to reconvene subject to the call of the Chair.]